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FAIR TAXATION

HEARINGS

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL TRADE, FINANCE, AND SECURITY ECONOMICS

AND THE

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY

OF THE

JOINT ECONOMIC COMMITTEE
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FAIR TAXATION

WEDNESDAY, JUNE 13, 1984

Congress of the United States,
Subcommittee on International Trade, Finance,
and Security Economics of the
Joint Economic Committee,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:10 a.m., in room 2255, Rayburn House Office Building, Hon. Gillis W. Long (chairman of the subcommittee) presiding.

Present: Representatives Long and Hamilton.

Also present: James K. Galbraith, deputy director; and William R. Buechner and Charles E. Ludlam, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE LONG, CHAIRMAN

Representative Long. The hearing will come to order.

The subject of today's hearing is fair taxation. I think you can just say fair taxation and it is clear that I am not referring to our current system of taxation. I don't think anybody thinks that our current tax system is fair. That's, of course, the problem.

The questions raised in this hearing are: How can we make our current tax system fairer and simpler? Just as important, what would be the effect on our economy if we did change our tax system?

There is no question but that the American people are unhappy with our current tax system. In a recent poll the Federal income tax was listed as the most unfair of all our taxes, worse than any other tax, including the property tax. In examining tax returns in 1982 the IRS found that 80 percent of all taxpayers made errors in computing their taxes. No wonder, then, that last year 40 percent of all taxpayers felt compelled to seek assistance from professional tax preparers in filling out their tax forms.

Everyone knows that tax cheating is on the rise. The Treasury Department estimated that only 89 percent of all taxable income is, in fact, reported to the Internal Revenue Service. This shortfall of $250 billion in unreported taxable income results in a revenue loss to the Federal Government of $91 billion per year. If this income was reported and the taxes paid on it, the current Federal deficit would be more than cut in half.

The Tax Code contains many perverse incentives. I don't know any other word to describe it than by calling these incentives perverse. There now are 105 special deductions, exemptions, and exclusions. These tax incentives channel capital into wasteful tax shelters rather than into productive capital investment. Avoidance of taxes is a goal in itself, whether or not it leads to productive investment.

Finally, our tax system doesn't even pay our Government bills. Even with the 1984 deficit reduction package, the Federal Government deficit will be $150 billion or more in each year through the end of the decade.

What we have then is an unfair tax system, one that is incomprehensible, easily evaded, and doesn't even raise enough revenue to run the Government.

Next year we will have a unique opportunity to do something about this mess. Because of the mammoth deficits and the outcry about the current tax system, next year we are going to have a major tax bill. Even the White House acknowledges this and the Treasury Department is analyzing various proposals to reform the tax system.

Perhaps you saw Secretary Regan's statement in the paper this morning about the flat tax or fair tax. What he says on this is all fine, but I think that it's a good time to put the administration on notice early in the game that it should not develop a mindset on tax reform. The administration should remember that Congress will have its own ideas—good ideas and strong ideas—about reforming the tax system. Congress knows that the current mess has been made much worse by the administration's 1981 tax bill. So this time the administration should keep an open mind to all the work that already has been done and is being done in the Congress to design a fairer and simpler tax.

If the administration will work with Congress, what might happen next year is we could do more than we have managed to do in the past—that is to tinker with the current Tax Code, changing this deduction, eliminating that exemption, and making everything more complicated. I hope we can do a great deal more than that. What really could happen next year is that we could replace the current unfair and wasteful tax system with a Tax Code that is simpler, fair, progressive, and efficient.

In considering a new tax system, however, we must be careful that we examine not only the tax consequences of the new system. We must also look at the economic consequences of any new system. For example, our current economic expansion is fueled largely by consumer consumption. If we changed our tax system to discourage consumption and encourage savings, would our economy grow as fast? We might have more savings to invest, but would consumers be buying as much of the goods we produce? This is the kind of question that the Joint Economic Committee can ask and can analyze and this hearing is just a start in that long road.

I am pleased to say that the House Democratic caucus, of which I am chairman, has been analyzing various proposals for overhauling our current tax system. In the view of the caucus, the best candidate for replacing the current tax system is the fair tax authored by Congressman Dick Gephardt and Senator Bill Bradley. In January of this year, the National House Democratic caucus issued "A Democratic Blueprint for Our Nation's Future." In the blueprint the caucus found that the fair tax "will help put capital back to work for growth." It "will encourage investment based on sound economic considerations."

I am pleased to say that the Democratic members of the Joint Economic Committee have endorsed the fair tax in our 1984 annual report. Copies of the "Blueprint" and the annual report recommendations on the fair tax are available here this morning.[1]

I think the momentum for this fair tax is building. Next year's debate on the tax bill could be historic. The purpose of this hearing today is to begin to lay groundwork for this debate by analyzing the fair tax.

[The information referred to follows:]

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[1] The "Blueprint" and Joint Economic Committee annual report recommendations appear on pp. 4 and 6, respectively.

THE FAIR TAX

FROM RENEWING AMERICA'S PROMISE: A DEMOCRATIC BLUEPRINT FOR OUR NATION'S FUTURE. THE NATIONAL-HOUSE DEMOCRATIC CAUCUS, WASHINGTON, D.C., JANUARY 1984

FAIR TAX

INITIATIVE NUMBER ONE: ***Replacement of the present tax code with a new simplified Fair Tax.*** Our present tax system is unfair and excessively complicated. It is a codification of concessions to special interests—with tax breaks for the wealthy and the clever and tax bills for the rest of us. It spans more than 2,000 pages. It contains more than 100 major personal and business loopholes that will be worth more than $250 billion this year. It fosters tax evasion—$81.5 billion worth in 1981. And, partly because it encourages so much tax cheating, it does not raise enough money to pay our bills.

The corporate code is no better. It is so filled with special tax preferences for one kind of investment or another that investments are too often made to cut tax payments rather than for sound economic reasons.

The Reagan tax giveaway made an unfair tax code even more unfair. The largest benefits went to the richest Americans. And Americans in the lowest tax brackets will find that their taxes have actually risen by the time the 1981 tax changes become fully effective.

But the largesse toward the rich pales when one examines what happened to corporate taxation in that same bill. When Harry Truman was President, individuals paid 60 percent of the total tax burden and corporations paid the rest. Under the Reagan tax plan, the individual share of the tax bill rises to 86 percent. In 1981, hundreds of American corporations found they had no tax liability at all as a result of the Reagan plan.

There is simply no way to repair the present code. Efforts to eliminate special tax loopholes and to raise taxes incrementally will not work. The power of single, organized interests is too great. We propose replacing the current tax structure with a Fair Tax. The new system would be simple, progressive and equitable and the rates it would set would match our needs to raise revenues to reduce the budget deficit.

Table 1: The Reagan Tax Giveaway

Losers and winners under the Reagan Republican Economic Recovery Tax Act of 1981 are shown below. Between 1982 and 1984, only the top five percent of all taxpayers will get significant tax cuts, while those who earn less than $30,000 a year will actually pay *more* in taxes.

Income	Rise or fall in tax bill due to Reagan tax program	Percentage of all taxpayers
Losers:		
$10,000 and under	+24%	32.2%
10–15,000	+7%	14.7%
15–20,000	+2%	12.1%
20–30,000	even	16.9%
Winners:		
$30–50,000	−1%	15.2%
50–100,000	−3%	4.0%
100–200,000	−8%	0.7%
Over $200,000	−15%	0.2%

CORPORATE TAXATION

Corporations which have received enormous tax breaks under the Reagan program will once again have to pay their fair share. So, too, will those who now hide part of their incomes from taxation behind the shelters in the current code.

These loopholes, beyond the unfairness they perpetuate and the contempt for the law they engender, distort the pattern of investment. Fostering only a search by lawyers and accountants for tax shelter, they steer capital away from productive opportunities, into tax avoidance schemes, out of job creation.

The proposed Fair Tax will help put capital back to work for growth. By overhauling the corporate income tax code, the Fair Tax system will encourage investment based on sound economic considerations.

The current tax code distorts investment decisions so that economically desirable investments often appear less attractive than those where tax incentives inflate profitability. Section after section tells new investors what lines of business to enter, tells existing corporations how to go about their work, and puts a heavy tax on the profits of successful and productive corporations. The whole system makes no economic sense.

The Fair Tax system would reward attainment of the real goal—profit—by taxing it at the lowest possible rate. Under such a system, firms could not increase their after-tax income by collecting tax preferences from tangential activities. Potential investors would get the highest returns by putting their capital where the market—not the tax law—tells them.

Tax subsidies for capital investment would be made more uniform and neutral. There would be a simple and more rational depreciation system. The new system would equalize the tax burdens on different kinds of assets, putting scarce capital to the most efficient use.

PRINCIPLES OF FAIRNESS

Under the Fair Tax Plan:

- *There will be a simple, progressive tax with a limited number of rates.*
- *Most taxpayers will pay only the lowest rate.*
- *The corporate and top individual rates will be the same, but both will be lower than now.*
- *Most income will be treated alike.*
- *The personal exemption for taxpayers and spouses and the standard deduction for single and joint returns would be increased.*
- *Most itemized deductions, credits and exclusions except those generally available to most taxpayers would be repealed. Retained will be exemptions for dependents, the elderly, and the blind; deductions for home mortage interest, charitable contributions, state and local income and real property taxes; exclusion of veterans' benefits, Social Security benefits for low and moderate income persons and interest on general obligation bonds.*
- *The personal exemptions and itemized deductions will apply only against the lowest rate.*
- *A new depreciation system that does not favor one type of asset over another would replace the current system.*

FROM REPORT OF THE JOINT ECONOMIC COMMITTEE, CONGRESS OF THE UNITED STATES: DEMOCRATIC VIEWS ON THE FEBRUARY 1984 ECONOMIC REPORT OF THE PRESIDENT, WASHINGTON, D.C., 1984.

1. TAXES

Any realistic attempt to reduce the deficits must include new tax measures.

We believe the time has come to replace the current tax code with a new, simplified tax that expands the tax base and reduces marginal tax rates while eliminating many corporate tax loopholes.

The changes made by the ERTA altered the tax burden among income groups and provided significantly more tax relief to those at the upper end of the income scale than to those at the lower end. While most tax rates were reduced by 23 percent during the four-year period 1981 to 1984, the tax rate in the top bracket, affecting only high-income taxpayers, was reduced in 1982 from 70 percent to 50 percent, a one-time 28 percent cut that was followed by further reductions for many upper-income taxpayers in 1983 and 1984.

The result, according to a study performed by the Congressional Research Service, is that upper-income taxpayers received a much larger tax break than their less fortunate counterparts at the other end of the income scale. For example, the real after-tax income of those earning $100,000 or more in 1980 will rise by an average of 5 to 9 percent by 1984 as a result of the Reagan tax cuts. Those with incomes under $25,000 can expect a real increase of 1 percent or even less.

Another study, prepared by the CBO, found that the average family with a 1982 household income of $10,000 or less will see its Federal tax bill go down by $250 by 1985. Those in the $200,000 and up category can expect a tax cut of $40,000 on average, 160 times the benefit received by the average lower income family. For the lower income family, the tax cut amounts to 2.3 percent of 1982 pretax income. For the family whose income exceeds $80,000, the tax break amounts to 8.4 percent of 1982 pretax income.

The Reagan Administration also succeeded in accelerating the long-term shift in the Federal tax burden from corporations to individuals. Corporate profit taxes accounted for more than 21 percent of Federal revenues during the decade of the 1960's. During the 1970's, this ratio fell to just over 16 percent, largely as a result of the reinstatement of the investment credit and adoption of the asset depreciation range system in the Revenue Act of 1971.

During the first years of the 1980's, the corporate share of Federal taxes was slashed in half, to just 8.0 percent. Although some of this erosion was offset by TEFRA increases in other forms of business taxes, the overall result of the Reagan Administration's erosion of the corporate tax has been to shift much of the Federal tax burden onto individual taxpayers.

Over the last three decades, the percent of corporate profits going to taxes has steadily declined, from almost 50 percent during the 1950's to just over 35 percent so far in the 1980's. Many industries pay far less. The steady reduction in the corporate tax rate to 46 percent accounted for some of this. But much of the erosion of the corporate profits tax must be laid at the doorstep of special tax expenditure provisions. These will reduce corporate tax payments by $75.9 billion in 1984, an amount greater than the $66.6 billion that the Administration estimates corporations will actually pay this year.

Our tax program would reverse this Administration's push to put more of the tax burden on lower- and middle-income taxpayers and give enlarged tax breaks to corporations and the well-to-do.

The Fair Tax Act proposed earlier this Congress by Senator Bill Bradley and Congressman Richard Gephardt shows how this could be done. This bill would establish a 14 percent basic rate for the individual income tax. Taxpayers having an income of over $40,000 on joint returns would pay a 12 percent surtax and those with over $65,000 would pay a 16 percent surtax, yielding a top marginal tax rate of 30 percent. The corporate rate would also be 30 percent. The revised tax code would include only a few deductions—those currently used by most households—including mortgage interest, State and local income taxes and real property taxes, charitable contributions, Individual Retirement Account (IRA) and Keogh contributions, and employee business expenses.[1] In addition, some income would be excluded as under current law, including veterans benefits, social security benefits for low-income and moderate-income taxpayers, and interest on general obligation bonds. Most of the special deductions and exemptions for corporations would be repealed under the Fair Tax proposal.

In order to provide increased revenues to match the spending cuts proposed elsewhere in this Report, Fair Tax rates would have to be set slightly higher than in the original Bradley-Gephardt proposal. The basic rate for individuals would be set at 15 percent, the intermediate rate at 27 percent and the top rate at 31 percent. The corporate rate is set at 30 percent. Table IV-1 presents an updated set of Fair Tax rates for individuals and corporations that would achieve our revenue targets through 1989.

TABLE IV-1.—FAIR TAX RATES

[In percent]

Income category	Marginal tax rate
Single taxpayers:	
Below $25,000	15
$25,000 to $37,500	27
Over $37,500	31
Married taxpayers:	
Below $40,000	15
$40,000 to $65,000	27
Over $65,000	31
Corporations	30

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[1] Senator Bentsen strongly endorses efforts to simplify the tax system and improve its equity and efficiency. In 1982, he called (S.J. Res. 206) for an extensive analysis of flat rate tax systems. The Fair Tax is one of many similar flat rate tax systems proposed since then. But until much more comprehensive information is available on these many proposals, especially including their transition effects, he has postponed endorsing any specific flat tax proposal, including the particular variation discussed in this section.

These tax rates do not require any general tax increase for lower and middle-income taxpayers. Virtually every married taxpayer making $40,000 or under and every unmarried taxpayer making less than $25,000 would pay no more tax than under the tax rates in effect in 1984.

Virtually all of the new revenues will come from upper-income taxpayers and corporations. Even among these groups, only those who are currently receiving significant tax breaks will face significant tax increases.

Nonetheless, all taxpayers, regardless of income level, will face lower marginal tax rates under the Fair Tax than under current law. Those taxpayers who pay more under the Fair Tax will find it is because they can no longer take advantage of the multitude of loopholes that have eroded our tax system.

Our revenue estimates for the Fair Tax are presented in Table IV-2. About 17 percent of the projected increase in Federal revenues would come from corporations, while the remaining 83 percent would come from individuals. Our revenues estimates assume a 1986 effective date for the Fair Tax, with some transitional base-broadening in 1985, and take account of the fact that tax brackets would not be indexed under this system.

The Fair Tax marks a significant improvement over the current tax system. It is a simple, progressive tax that nonetheless incorporates much lower marginal tax rates than the current law. Most income, regardless of source, will be treated alike and face the same tax rates. Most itemized deductions, credits, and exclusions would be repealed except for those generally available to most taxpayers. Many provisions that erode the corporate tax base would be repealed and a new depreciation system that does not interfere with investment incentives would replace the current system.

TABLE IV-2.—FAIR TAX ACT REVENUE ESTIMATES

[In billions of dollars]

Category	Fiscal years				
	1985	1986	1987	1988	1989
Current revenues	733	795	863	945	1,016
Individual	329	362	396	438	478
Corporate	65	71	81	85	85
Other	339	362	386	422	453
Fair tax		830	923	1,020	1,097
Individual		396	439	492	546
Corporate		71	89	99	99
Other		362	386	422	453
Increase over current revenues:					
Billions of dollars	[1] 17	34	51	68	82
Percent	2.3	4.3	5.9	7.2	8.0

[1] Transitional base-broadening measures prior to introduction of Fair Tax in 1986.

Representative LONG. I am pleased to have the two authors of this proposal here with us. Both of them are outstanding Members of the Congress of the United States and we are pleased to have you gentlemen, Senator Bradley and Congressman Gephardt. You may proceed in your own way.

STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator BRADLEY. Mr. Chairman, thank you very much for the opportunity to appear before the committee with Dick Gephardt. I would ask unanimous consent that the prepared statement that I have be printed in the record as well as a series of backup material.

Representative LONG. Without objection, so ordered.

Senator BRADLEY. Mr. Chairman, there's clearly a growing consensus that the tax system is urgently in need of reform. This morning I would like to explain why that consensus has evolved and lay out what our responses to that growing consensus for change are.

"Taxes," said the great Supreme Court Justice Oliver Wendell Holmes, Jr., "are the price that we pay for a civilized society."

Until recently, Americans felt that the price we paid for the benefits of our society was pretty reasonable. Paying taxes was never a happy task, but most of us paid willingly and honestly, confident that our neighbors were paying their fair share as well.

But our income tax is not working that way any more. It is unfair. It is overly complex. It is distorting investment decisions. It encourages people to put money into schemes to reduce their taxes instead of enterprises to create jobs and spur growth.

And the American people know it. Polls consistently show that a majority of Americans believe the present tax system is fundamentally unfair. They believe that middle and lower income people pay more taxes than the wealthy. They resent the thick, incomprehensible book of instructions that arrives each year at tax time.

Most of all, they want lower tax rates for everyone.

There is no mystery why people feel this way. Let me give you a few examples.

In 1981, families who reported income of more than $1 million paid an effective tax rate of less than 18 percent. They did it legally through the use of loopholes.

In 1984, a family with $29,000 in income may pay $3,560 in Federal income taxes. Another family with the same income using a few common loopholes may pay only $2,830, about 20 percent less. A third family with $29,000 income may pay nothing at all.

The current Tax Code is over 2,000 pages long. This is already twice as long as the Bible. The pending tax bill will add several hundred more pages to that code.

At a time when our economy is facing tough challenges from foreign competition, the tax system has created an entire industry—the tax shelter industry—devoted to the inefficient use of capital. That industry employs thousands of talented people to find schemes to reduce investors' tax bills, instead of building new industries our Nation needs to remain the world's leading economic power.

As loopholes and shelters have developed, the tradition of voluntary compliance on which our system depends has greatly weakened. The IRS estimates that since 1973, unreported income has ballooned from about $94 billion to over $250 billion in 1981. This translates, as you pointed out in your opening statement, into an increase in lost tax revenues that has grown from about $29 billion in 1973 to almost $82 billion in 1981. By now, that figure is approaching $100 billion. In other words, the tax system is cheating the vast majority who do pay all their taxes.

And the majority knows it.

Our loss of confidence in the tax system is well founded. Just as we have lost confidence in the tax system, so we have lost faith in our Government as a whole, in its ability to respond to our needs and to help us solve our problems.

This is a vicious cycle. The unfairness of our tax laws makes us lose confidence in Government. The less confidence we have in Government, the less willing we are to pay the taxes needed to support it. And the harder we try to avoid paying taxes, the more unfair the system appears. In turn, this pervasive perception of unfairness weakens the bonds of our American community. And it threatens to undermine the fundamental principles on which our society is built. It is small wonder, therefore, that in 1980, a Yankelovitch survey found more than 80 percent of the public agreeing that you could not get ahead in America if you played by the rules.

Well, despite this bleak picture, Dick Gephardt and I believe there is a solution. We can restore integrity to the tax system. And by doing so, we can begin restoring confidence in Government. That solution is called the fair tax.

The fair tax is essentially an approach that lowers rates dramatically and eliminates many tax loopholes. For individuals, the fair tax would eliminate many of the exclusions and deductions taxpayers now use. However, we would retain those deductions that are claimed by the majority of taxpayers who itemize, things like home mortgage interest, charitable and medical expenses, State and local income and property taxes, and a few others described in the detailed explanation of the bill I asked to submit for the record prior to the testimony.

For corporations, we have a 30-percent tax rate that would also do away with most tax preferences.

In sum, the fair tax cleans up the corporate income tax just as it does the individual income tax. With lower rates and fewer loopholes, it shifts the emphasis from tax minimization to profit and progress.

If we put more of our energy into building better products instead of dodging the IRS, our corporations will win battles in the marketplace, not just in tax court.

Let me be perfectly candid with you and the committee. The fair tax is not a free lunch. The fair tax is not a traditional tax cut, even though 70 percent of the taxpayers will be paying the same or less. It will collect the same amount of revenue as current law in its first year, and about $25 billion a year more in the next 2 years.

The fair tax is not a redistribution scheme. It will collect about the same amount of revenue from each income group as we now do. In the materials I submitted earlier is a letter from the Joint Tax Committee on revenue and distributional effects of the fair tax.

What the fair tax is, in summary, is a plan to lower rates and close loopholes at the same time. It does not pander to any one group. It touches just about everyone's loopholes and it lowers everyone's tax rates. So it increases everyone's incentive to work, save, and invest. This is good for the economy.

The fair tax determines everyone's taxes at low, fair rates, without gimmicks for some people to duck their fair share. This is good for the country.

There are alternative plans for restructuring the Tax Code. However, I believe that none of them has the broad appeal of the fair tax.

Some of these alternatives, like the flat tax and the consumption tax, are redistribution schemes designed and disguised as tax reform. A simple flat rate tax system would increase taxes for middle-income taxpayers and give big cuts to the wealthy.

A consumption tax would put an unfair burden on people whose incomes were reduced by retirement, unemployment, illness, or other uncontrollable circumstances. At the same time, a consumption tax would greatly advantage those who had already accumulated substantial wealth.

The fair tax has none of these drawbacks. It neither redistributes the tax burden nor bankrupts the Treasury.

Even so, not everyone supports this kind of sweeping tax reform, no matter how clear its advantages are. One political pundit put it quite starkly. He said, "The fair tax will never pass because the special interests oppose it, and the people do not care." He may be right about the special interests, Mr. Chairman, but I believe he is dead wrong about the people.

That is where political leadership comes into play. It is time we asserted the general interest—the interest of all Americans in having a Government they can believe in—over the narrower interests that too often seem to have seized control of our political life.

We need a tax system that is fair, a tax system that is understandable, a tax system that promotes growth by improving the way our economy allocates resources.

This is not a Democratic or a Republican idea. It is a national idea that should prompt all of us to look beyond individual short-term profits toward our long-run common interests.

So as I see it, Mr. Chairman, fair taxation is an issue bigger than any question of loopholes, bigger even than the challenge of rebuilding a reasonable tax system. It is a question of taking a first step toward making Government once again worthy of our confidence and respect.

That is what the fair tax bill is all about and that's why I am pleased to be here with my colleague and partner, Dick Gephardt. I appreciate the chance to come before you and make this presentation.

[The prepared statement of Senator Bradley, together with the backup material referred to, follows:]

PREPARED STATEMENT OF HON. BILL BRADLEY

MR. CHAIRMAN: It is a great pleasure for me to be here this morning. I commend the Committee for holding these hearings on Fair Taxation. It is one of the most important issues on our national agenda. In the months ahead, it will doubltless be the focus of even greater attention. So I congratulate this Committee's foresight in starting the discussion now.

There is a growing consensus that our tax system is urgently in need of reform. This morning I would like to explain why that consensus has evolved and to lay out my program for restructuring the Federal income tax to make it fairer, simpler and more efficient.

"Taxes," said the great Supreme Court Justice Oliver Wendell Holmes, Jr., "are the price we pay for a civilized society."

Until recently, most Americans felt that the price we paid for the benefits of our society was pretty reasonable. Paying taxes was never a happy task. But most of us paid willingly and honestly, confident that our neighbors were paying their fair shares as well.

But our income tax is not working that way any more.

It is unfair.

It is overly complex.

It is distorting investment decisions.

It encourages people to put money into schemes to reduce their taxes instead of enterprises to create jobs and spur growth.

And the American people know it. Polls consistently show that a majority of Americans believe the present tax system is fundamentally unfair. They believe that middle and lower income people pay more taxes than the wealthy. They resent the thick, incomprehensible book of instructions that arrives at tax time each year.

And most of all, they want lower tax rates for everyone.

There is no mystery why people feel this way. Let me give you a few examples:

--In 1981, families who reported income of more than $1 million paid an effective tax rate of less than 18%. And they did it legally through the use of loopholes.

--In 1984, a family with $29,000 in income may pay $3,560 in Federal income taxes. Another family with the same income using a few common loopholes may pay only $2,830, about 20% less. And a third family with $29,000 income may pay nothing at all.

--The current tax code is over 2,000 pages long. This is already twice as long as the Bible. And the pending tax bill will add several hundred more pages.

--At a time when our economy faces tough challenges from foreign competition, the tax system has created an entire industry--the tax shelter industry--devoted to the inefficient use of capital. That industry employs thousands of talented people to find schemes to reduce investors' tax bills, not to build the new industries our nation needs to remain the world's leading economic power.

--As loopholes and shelters have sprung up, the tradition of voluntary compliance on which our system depends has greatly weakened. The IRS estimates that since 1973, unreported income has ballooned from about $94 billion to almost $250 billion in 1981. This translates into an increase in lost tax revenues that has grown from about $29 billion in 1973 to almost $82 billion in 1981. And by now, that figure is approaching $100 billion. In other words, the tax system is cheating the vast majority who do pay all their taxes.

And the majority knows it.

Our loss of confidence in the tax system is well-founded. And just as we have lost confidence in the tax system, so we have lost faith in our government as a whole. In its ability to respond to our needs and to help us solve our problems.

This is a vicious cycle. The unfairness of our tax laws makes us loose confidence in government. The less confidence we have in government, the less willing we are to pay the taxes needed to support it. And the harder we try to avoid paying taxes, the more unfair the system appears. In turn, this pervasive perception of unfairness weakens the bonds of our American community. And it threatens to undermine the fundamental principles on which our society is built. It is small wonder that a 1980 Yankelovitch survey found more than 80% of the public agreeing that you could not get ahead if you played by the rules.

Despite this bleak picture, I believe there is a solution. We can restore integrity to the tax system. And by doing so, we will begin restoring confidence in government.

My solution is called the Fair Tax.

The Fair Tax, which Congressman Dick Gephardt and I introduced last year, would lower tax rates for all Americans. At the same time, it would eliminate the special interest provisions that reward the few at the expense of higher rates for the many.

The tax revenues gained from abolishing those loopholes would make it possible for everyone's tax rates to be reduced. That would encourage the work and investment we need for long-term economic growth.

For individuals, the Fair Tax would eliminate many of the exclusions and deductions taxpayers now use. However, it would retain those deductions claimed by the majority of taxpayers who itemize, such as home mortgage interest, charitable contributions, some medical expenses, and state and local income and property taxes. (Mr. Chairman, I ask that a detailed description of the Fair Tax be included in the record).

In return, the bill would lower tax rates and replace the present complex rate structure with a simplified one. Individuals would pay one of three tax rates--14, 26 or 30%. Four out of five taxpayers would pay only the lowest (14%) rate. About 70% of the taxpayers would pay less, or at least no more, tax than under present law; 30% of the taxpayers would pay more tax.

For corporations, the Fair Tax would set a single tax rate of 30%. It would do away with most of the tax preferences that now selectively reduce tax liability and distort investment decisions.

The tax subsidies for capital investment would be made more uniform and neutral. There would be a simpler, more rational depreciation system. The new system would equalize the tax burdens on different kinds of assets, putting capital to the most efficient use.

In sum, the Fair Tax cleans up the corporate income tax just as it does the individual income tax. With lower rates and fewer loopholes, it shifts the emphasis from tax minimization to profit and progress.

If we put more of our energy into building better products instead of dodging the IRS, our corporations will win battles in the market place, not just in the Tax Court.

Let me be perfectly candid with you. The Fair Tax is not a free lunch:

--The Fair Tax is not a traditional tax cut, even though 70% of the taxpayers will be paying the same or less. It will collect the same amount of revenue as the current tax law in its first year and about $20-25 billion a year more thereafter.

--The Fair Tax is not a redistribution scheme. It will collect about the same amount of revenue from each income group as we do now. (Mr. Chairman, I ask that a letter from the Joint Tax Committee on the revenue and distributional effects of the Fair Tax be included in the record at this point).

What the Fair Tax is, is a plan to lower rates and close loopholes--together. It does not pander to any one group. It touches just about everyone's loopholes and it lowers everyone's tax rates. So it increases everyone's incentive to work, save and invest. This is good for the economy.

The Fair Tax determines everyone's taxes at low, fair rates, without gimmicks for some people to duck their fair share. And this is good for the country.

There are alternative plans for restructuring the tax code. However, I believe that none of them has the broad appeal of the Bradley-Gephardt approach.

Some of these alternatives, like the flat tax and the consumption tax, are redistribution schemes disguised as tax reform. A simple flat rate tax system would increase taxes for middle income taxpayers and give big cuts to the wealthy.

A consumption tax would put an unfair burden on people whose incomes were reduced by retirement, unemployment, illness or other uncontrollable circumstances. At the same time, a consumption tax would greatly advantage those who had already accummulated substantial wealth.

The Fair Tax has none of these drawbacks. It neither redistributes the tax burden nor bankrupts the Treasury.

Even so, not everyone supports this kind of sweeping tax reform, no matter how clear its advantages are. One political pundit put it quite starkly: "The Fair Tax will never pass because the special interests oppose it and the people do not care." He may be right about the special interests. But I believe he is dead wrong about the people.

That is where political leadership comes into play. It is time we asserted the general interest--the interest of all Americans in having a government they can believe in--over the narrow interests that too often seem to have seized control of our political life. We need:

--A tax system that is fair.

--A tax system that is understandable.

--A tax system that promotes growth by improving the way our economy allocates resources.

This is not a Democratic or a Republican idea. It is a national idea that should prompt all of us to look beyond individual short-term profits toward our long-run common interests.

So as I see it, Mr. Chairman and members of this Committee, Fair Taxation is an issue bigger than any question of loopholes: bigger even than the challenge of rebuilding a reasonable tax system. It is a question of taking a first step toward making government once again worthy of our confidence and respect.

That is what Fair Taxation and the Bradley-Gephardt Fair Tax are all about.

Bill Bradley
U.S. SENATOR
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BRADLEY-GEPHARDT ANNOUNCE FAIR TAX PETITION DRIVE

For immediate release: Thursday, April 12, 1984
Contact: Lisbeth Pettengill, Leslie Devlin 202/224-3224

WASHINGTON — Sen. Bill Bradley, D-N.J., and Rep. Richard Gephardt, D-Mo., today launched a national petition drive to support their Fair Tax legislation.

Sen. Bradley brought to the announcement more than 6,500 pieces of mail which had arrived at his office to request petitions in support of the legislation. The Senator said, "The people want a tax system that is simple and fair, and they are obviously willing to roll up their sleeves to work for it."

"When Congressman Gephardt and I first drafted the Fair Tax bill, we realized that such a dramatic tax reform could only succeed in one way -- through the support of a nationwide grassroots movement. We know that many special interest groups will oppose this tax reform, so we need widespread public support.

"We want to make this a populist movement. We began by educating the public about the problems with the current tax system and what should be done to change it. Then, we encouraged those who shared our views to set up the Fair Tax Foundation. Today we are launching a petition drive for the Fair Tax.

"Our first gauge of the appeal the Fair Tax might have for citizens came after an appearance that Congressman Gephardt and I made on the Donohue Show two weeks ago. Since that time, we have received more than 6,000 pieces of mail from people asking to have petitions sent to them."

Sen. Bradley will host two separate tax speak-outs in New Jersey on April 14 to talk with his constituents about the Fair Tax and to start a petition drive in his home state.

-end-

FACT SHEET ON THE BRADLEY-GEPHARDT

"FAIR TAX ACT OF 1983"

This legislation will make the federal income tax system simpler and fairer and the economy more efficient. It will reduce tax rates and eliminate most existing deductions, credits and exclusions. It also will raise revenues approximately equal to those collected under existing law without changing the tax burden for any income group.

SUMMARY OF KEY POSITIONS

FOR INDIVIDUALS

- o A simple, progressive tax with three rates: 14%, 26% and 30%.
- o About 80% of all taxpayers will pay only the 14% rate. The 26% rate will apply only to individuals with adjusted gross incomes exceeding $25,000 and to couples with adjusted gross incomes exceeding $40,000. The top rate of 30% will apply only to individuals with adjusted gross incomes over $37,500 and couples with adjusted gross incomes over $65,000.
- o An increase of the personal exemption from $1,000 to $1,600 for taxpayers and spouses ($1,800 for a single head of household) and an increase in the standard deduction from $2,300 to $3,000 for single returns and from $3,400 to $6,000 for joint returns. A family of four could earn up to $11,200 before receiving their first dollar of taxable income.
- o Repeal of most itemized deductions, credits and exclusions except those generally available to most taxpayers. Retained will be the $1,000 exemptions for dependents, the elderly and the blind; deductions for home mortgage interest, charitable contributions, state and local income and real property taxes, payments to IRAs and Keogh plans and employee business expenses; exclusion of veterans benefits, Social Security benefits for low and moderate income persons and interest on general obligation bonds. The personal exemptions and itemized deductions will apply only against the 14% rate.

FOR CORPORATIONS

- o A tax rate of 30%.
- o Repeal of most existing tax deductions, credits and exemptions that distort investment decisions.
- o A new depreciation system that doesn't favor one type of asset over another.

TECHNICAL EXPLANATION

The legislation significantly reduces tax rates and broadens the base of the individual and corporate income taxes by eliminating most tax preferences. It also smoothes out the rate schedule of the tax and sharply reduces "bracket creep" and the "marriage penalty". The changes are designed as if they were to take effect in 1985 and they are approximately revenue and distribution neutral with respect to tax liability in that year. Transition questions will require that some tax preferences be phased out gradually rather than changed abruptly. However, to establish lower rates and a broader tax base as the direction for federal tax policy, 1985 serves as the baseline date for all the analysis.

Individual income tax structure

For about 80% of individuals, the income tax is a uniform 14% tax on taxable income (the base tax). Taxable income is net of personal exemptions and either the standard deduction or the allowable itemized deductions. The personal exemptions are $1,600 per taxpayer (i.e., $1,600 on a single return and $3,200 on a joint return) and $1,000 per dependent. Single heads of households receive an exemption of $1,800. The extra exemptions for the elderly and blind continue at $1,000. The zero bracket amount (standard deduction) increases to $3,000 for single returns and $6,000 for joint returns ($3,000 for separate returns of married persons).

For upper income taxpayers, the regular 14% income tax is supplemented by an additional progressive tax (surtax) of 12% and 16% on adjusted gross income in excess of $25,000 for single returns and $40,000 for joint returns. Only about 20% of all taxpayers are subject to this surtax. The combined effect of the 14% base tax and the surtax is a top marginal tax rate of 30%.

The personal exemptions and itemized deductions retained in the Fair Tax apply only against the 14% base tax. The rate schedule is as follows:

AGI	Surtax rate	Combined tax rate
	Single returns	
Below $25,000	No surtax	14%
$25,000 to $37,500	12%	26%
Over $37,500	16%	30%
	Joint returns	
Below $40,000	No surtax	14%
$40,000 to $65,000	12%	26%
Over $65,000	16%	30%

For married persons filing separately, the tax brackets are half of the joint return tax brackets.

Corporate tax structure

The corporate income tax rate is set at a uniform 30% of taxable income thus eliminating graduation in corporate rates.

Base Broadening Measures

A. Changes affecting individuals and unincorporated businesses:

1. The exclusions for income earned abroad by U.S. citizens, residents or government employees (secs. 911 and 912) are repealed.

2. 7 year amortization for reforestation expenditures (sec. 194) is repealed.

3. 5 year amortization for pollution control facilities (sec. 169) is repealed.

4. Expensing of tertiary injectants (sec. 193) is repealed. Instead, these costs will be written off over 2 years.

5. A new depreciation method is provided for equipment and structures. Under the proposal, equipment is divided into 6 classes based on its ADR midpoint. An open ended account will be established for each asset class and each class will be given a class life. Each year taxpayers write off a percentage of the balance in the account computed using the class life and the 250% declining balance method. Additions to each account will be made each year for purchases of assets in that class and subtractions will be made for dispositions of assets and for that year's depreciation deduction. Structures will be put into the sixth asset class. The asset classes and depreciation rates for equipment are as follows:

ADR Midpoint	Class life
Under 5	4
5.0 to 8.5	6
9.0 to 14.5	10
15 to 24	18
25 to 35	28
Over 35 and structures	40

   For example, equipment with an ADR life of 10 years will be in the 10-year class. Thus, the first year's write-off will be 25% of the cost (2.5/10 = .25), the second year's write-off will be 18.75% (25% of 75%) and so forth.

   This plan is designed so that the present value of depreciation deductions is approximately equal to the present value of economic depreciation at a 10% discount rate.

6. Percentage depletion (secs. 613 and 613A) and expensing of intangible drilling costs for oil, gas and geothermal wells (sec. 263(d)) are repealed. Instead, there is a new system of capital cost recovery. Under this system, intangible drilling costs and those costs currently recovered through the depletion deduction will be written off under the same method applicable to equipment in the 10-year class. All costs incurred with respect to dry holes will be deducted when the well or property is abandoned.

7. Limits on qualified pension plans (sec. 415) are reduced from $30,000 on defined contribution plans and $90,000 on defined benefit plans to $15,000 and $45,000, respectively, and indexing of those limits is repealed.

8. The finance lease property rules (sec. 168(f)) are repealed and the pre-1981 law is restored.

9. The regular investment tax credit (sec. 46(a) (2) (B)) is repealed.

10. The research and development credit (sec. 44F) is repealed.

11. The credit for rehabilitation of buildings (sec. 46(a) (2) (F) is repealed.

12. The business energy tax credits (secs. 46(a) (2) (c), 44D and 44E) are repealed.

13. All individual farms with gross receipts of more than $1 million and all farm syndicates will be required to use accrual accounting and to capitalize pre-production period expenses and cannot use the expensing provisions for soil and water conservation expenditures (sec. 175), fertilizer (sec. 180), or land clearing (sec. 182).

14. Individuals with AGI above $100,000 would have to cover 90% of current year's tax liability with estimated or withheld tax payments
15. Income averaging (sec. 1301) is repealed.

16. The child care credit (sec. 44A) is converted to a deduction for purposes of the base tax but not the surtax. The deduction is allowed to non-itemizers.

17. The political contribution tax credit (sec. 41) is repealed.

18. The exclusion of Tier II of Railroad Retirement benefits is repealed.

19. The exclusion for interest on cash value life insurance (sec. 804(a)) is repealed. Life insurance policholders will include in gross income an amount equal to the increase int he cash surrender value of their policy during the year plus policyholder dividends received plus the "term insurance" value of insurance protection during the year minus the premiums paid. Insurance companies will provide policyholders with this information.

20. The exclusion for scholarship and fellowship income in excess of tuition (sec. 117) is repealed.

21. The deduction for second earners (sec. 221) is repealed because the new rate schedule sharply reduces the "marriage penalty".

22. The elderly tax credit (sec. 37) is repealed.

23. The general exclusions for interest and dividends (secs. 116 and 128) and the exclusion for reinvested public utility dividends (sec. 305(e)) are repealed.

24. Expensing of interest and taxes paid during the construction period of a building (sec. 189) is repealed and instead these costs are subject to a 10 year amortization.

25. The residential energy credit (sec. 44C) is repealed.

26. The deduction for 60% of net long-term capital gains (sec. 1202) is repealed and the distinction between short- and long-term capital gains is eliminated.

27. The individual minimum tax (sec. 55) is repealed. Since the legislation eliminates most of the preferences currently subject to the minimum tax, this provision is no longer needed.

28. The exclusion for unemployment compensation benefits (sec. 85) is repealed.

29. The exclusions for employer provided child care (sec. 129), education assistance (sec. 127) and group legal services (sec. 120) are repealed.

30. For purposes of computing the surtax (but not the base tax), a deduction would be allowed for all interest to the extent of investment income. For the base tax, itemized deductions would be allowed for all housing interest, and the itemized deduction for other interest would be limited to investment income.

31. The exclusion for employer provided premiums on group term life insurance (sec. 79) is repealed.

32. The tax exemption for industrial development or housing bonds issued after December 31, 1984 (secs. 103(b) and 103A) is repealed.

33. Rapid amortization of low-income housing rehabilitation (sec. 167(k)) is repealed.

34. The itemized deduction for medical expenses (sec. 213) is limited to the excess over 10% of adjusted gross income.

35. The present exclusion for up to $125,000 of gain on the sale of a house by a person age 55 or over (sec. 121) is retained for the base tax but not the surtax.

36. The deduction for adoption expenses (sec. 222) is repealed.

37. The deduction for state and local income and real property taxes is retained but the deduction for all other state and local taxes (sec. 164) is repealed.

38. The exclusion for employer provided premiums on group health insurance (sec. 106) is repealed.

39. Indexing of the personal exemptions and the tax brackets (sec. 1(f)) is repealed because the new rate structure will greatly reduce the problem of "bracket creep."

40. Trusts and estates would be subject to a flat 30% tax on taxable income in excess of $100. As under present law, a deduction would be allowed for distributions.

B. Changes affecting corporations:

1. A new depreciation method is provided for equipment and structures. Under the proposal, equipment is divided into 6 classes based on its ADR midpoint. An open ended account will be established for each asset class and each class will be given a class life. Each year taxpayers write off a percentage of the balance in the account computed using the class life and the 250% declining balance method. Additions to each account will be made each year for purchases of assets in that class and subtractions will be made for dispositions of assets and for that year's depreciation deduction. Structures will be put into the sixth asset class. The asset classes and depreciation rates for equipment are as follows:

ADR Midpoint	Class life
Under 5	4
5.0 to 8.5	6
9.0 to 14.5	10
15 to 24	18
25 to 35	28
Over 35 and structures	40

For example, equipment with an ADR life of 10 years will be in the 10-year class. Thus, the first year's write-off will be 25% of the cost (2.5/10 = .25), the second year's write-off will be 18.75% (25% of 75%) and so forth.

This plan is designed so that the present value of depreciation deductions is approximately equal to the present value of economic depreciation at a 10% discount rate.

2. Percentage depletion for minerals (sec. 613) and expensing of mineral exploration and development costs (sec. 616 and 617) are repealed. Instead, there is a new system of capital cost recovery whereby exploration and development costs are deducted under an open account system based on 6 asset classes. These 6 classes are the same as those for equipment. Mines will be assigned to one of the 6 asset classes based on the expected useful life of the mine (using the same system that assigns equipment to each class based on its asset depreciation range (ADR) midpoint).

3. Percentage depletion (secs. 613 and 613A) and expensing of intangible drilling costs for oil, gas and geothermal wells (sec. 263(d)) are repealed. Instead, there is a new system of capital cost recovery. Under this system, intangible drilling costs and those costs currently recovered through the depletion deduction will be written off under the same method applicable to equipment in the 10-year class. All costs incurred with respect to dry holes will be deducted when the well or property is abandoned.

4. The income of controlled foreign subsidiaries of U.S. corporations is subject to tax.

5. The preferential taxation of Domestic International Sales Corporations (DISC) (sec. 991) is repealed and previously deferred DISC income is recaptured over a 10 year period.

6. The deduction for bad debt reserves of financial institutions in excess of their actual experience (secs. 585 and 593) is repealed.

7. The exclusion for contributions to a maritime construction fund is repealed.

8. The finance lease property rules (sec. 168(f)) are repealed and the pre-1981 law is restored.

9. The regular investment tax credit (sec. 46(a) (2) (B)) is repealed.

10. The credit for possessions corporations (sec. 936) is repealed.

11. The research and development credit (sec. 44F) is repealed.

12. The credit for rehabilitation of buildings (sec. 46(a) (2) (F)) is repealed.

13. The business energy tax credits (secs. 46(a) (2) (c), 44D and 44E) are repealed.

14. The employer stock ownership credit (sec. 44G) is repealed.

15. For corporations, the deduction for charitable contributions is limited to one-half of such contributions. Thus they will receive a 15% tax benefit for charitable giving.

16. All corporate farms with gross receipts of more than $1 million and all farm syndicates will be required to use accrual accounting and to capitalize pre-production period expenses and cannot use the expensing provisions for soil and water conservation expenditures (sec. 175), fertilizer (sec. 180), or land clearing (sec. 182).

17. For taxpayers using the completed contract method, the 3-year exception is deleted and a "look-back" method, imposing interest charges on deferred tax liability, is implemented.

18. The alternative capital gains rate for corporations (sec. 1201) is repealed.

19. The exemption for credit unions (sec. 501(c) (14)) is repealed.

20. Expensing of magazine circulation expenditures (sec. 173) is repealed. Instead, these costs will be amortized over 10 years.

21. Expensing of tertiary injectants (sec. 193) is repealed. Instead, these costs will be written off over 2 years.

22. The exclusion of income attributable to a stock-for-debt swap (sec. 108) is repealed.

23. Upon liquidation, a corporation will recognize gain on all appreciated assets (secs. 336 and 337).

24. 7 year amortization for reforestation expenditures (sec. 194) is repealed.

25. 5 year amortization for pollution control facilities (sec. 169) is repealed.

26. Expensing of interest and taxes paid during the construction period of a building (sec. 189) is repealed and instead these costs are subject to a 10 year amortization.

27. The corporate minimum tax (sec. 56) is repealed. Since the legislation eliminates most of the preferences currently subject to the minimum tax this provision is no longer needed.

28. The tax exemption for industrial development or housing bonds issued after December 31, 1984 (secs. 103(b) and 103A) is repealed.

29. Rapid amortization of low-income housing rehabilitation (sec. 167(k)) is repealed.

SINGLE TAXPAYER #1

	1984 Law	Proposal
Income: Salary	15,000	15,000
Plus: Employer paid health	--	1,200
Employer paid life	--	150
Equals: ADJUSTED GROSS INCOME	15,000	16,300
Less: Exemption	1,000	1,600
Equals: TAXABLE INCOME	14,000	14,750
TAX	1,801*	1,645**
Marginal tax rate	20%	14%

* From 1984 law tax rate tables

** Taxable income less $3,000 zero bracket amount times 14 percent tax rate

MARRIED TAXPAYER #1

	1984 Law	Proposal
Income: Salary	15,000*	15,000
Less: Two earner deduction	500	--
Plus: Employer paid life insurance	--	1,200
Employer paid health insurance	--	150
Equals: ADJUSTED GROSS INCOME	14,500	16,350
Less: Exemptions	4,000	5,200
Equals: TAXABLE INCOME	10,500	11,150
TAX	889**	721***
Marginal tax rate	14%	14%

* Assumed $10,000 earned by one spouse, $5,000 by other

** From 1984 law rate tables

*** Taxable income less $6,000 zero bracket amount times 14 percent tax rate

SINGLE TAXPAYER #2

		1984 Law	Proposal
Income:	Salary	30,000	30,000
Plus:	Employer paid health insurance	--	1,200
	Employer paid life insurance	--	300
Equals:	ADJUSTED GROSS INCOME	30,000	31,500
Less:	Exemption	1,000	1,600
Equals:	TAXABLE INCOME	29,000	29,900
TAX		5,773*	4,546**
Marginal tax rate		34%	26%

* From 1984 law rate tables

** Taxable income less $3,000 zero bracket amount times 14 percent rate, plus surtax (12 percent of AGI over $25,000)

MARRIED TAXPAYER #2

	1984 Law	Proposal
Income: Salary	30,000*	30,000*
Less: Two earner deduction	1,000	--
Plus: Employer paid health insurance	--	1,200
Employer paid life insurance	--	300
Equals: ADJUSTED GROSS INCOME	29,000	31,500
Less: Exemptions	4,000	5,200
Child Care deduction	--	2,000
Equals: TAXABLE INCOME	25,000	24,300
TAX BEFORE CREDIT	3,565**	2,562***
Less: Child Care Credit	400	--
Equals: TAX AFTER CREDIT	3,165	2,562
Marginal tax rate	25%	14%

* Assumed $20,000 earned by one spouse, $10,000 by the other

** From 1984 law rate tables

***Taxable income less $6,000 zero bracket amount times 14 percent tax rate

SINGLE TAXPAYER #3

		1984 Law	Proposal
Income: Salary		30,000	30,000
Plus:	Employer paid health insurance	--	1,200
	Employer paid life insurance	--	300
Equals: ADJUSTED GROSS INCOME		30,000	31,500
Itemized deductions:	Mortgage interest	3,000	3,000
	Property taxes	1,000	1,000
	Sales taxes	250	--
	Income taxes	1,200	1,200
	Charitable contributions	500	500
	TOTAL	5,950	5,700
Less:	Zero bracket amount	2,300	3,000
Equals:	EXCESS ITEMIZED DEDUCTIONS	3,650	2,700
AGI		30,000	31,500
Less: Exemptions		1,000	1,600
Less: Excess itemized deductions		3,650	2,700
Equals: TAXABLE INCOME		25,350	27,200
TAX		4,670*	4,168**
Marginal tax rate		30%	26%

* From 1984 law rate tables

** Taxable income less $3,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI over $25,000).

MARRIED TAXPAYER #3

	1984 Law	Proposal
Income: Salary	30,000*	30,000*
Less: Two earner deduction	1,000	--
Plus: Employer paid health insurance	--	1,200
Employer paid life insurance	--	300
Equals: ADJUSTED GROSS INCOME	29,000	31,500
Itemized deductions: Mortgage interest	3,000	3,000
Property taxes	1,000	1,000
Sales taxes	400	--
Income taxes	1,000	1,000
Charity	500	500
TOTAL	5,900	5,500
Less: Zero bracket amount	3,400	6,000
Equals: EXCESS ITEMIZED DEDUCTIONS	2,500	0
AGI	29,000	31,500
Less: Exemptions	4,000	5,200
Excess itemized deductions	2,500	0
Child care deduction	--	2,000
Equals: TAXABLE INCOME	22,500	24,300
TAX BEFORE CREDIT	3,003**	2,562***
Less: Child care credit	400	--
Equals: TAX AFTER CREDIT	2,603	2,562
Marginal tax rate	22%	14%

* Assumed $20,000 earned by one spouse, $10,000 by the other

** From 1984 law rate tables

*** Taxable income less $6,000 zero bracket amount times 14 percent tax rate

SINGLE TAXPAYER #4

	1984 Law	Proposal
Income: Salary	60,000	60,000
Dividends	100	100
Less: Dividend exclusion	100	--
Plus: Employer paid health insurance	--	1,200
Employer paid life insurance	--	600
Equals: ADJUSTED GROSS INCOME	60,000	61,900
Itemized deductions:		
Mortgage interest	4,800	4,800
Property taxes	2,000	2,000
Sales taxes	700	--
Income taxes	3,000	3,000
Charitable contributions	1,500	1,500
TOTAL	12,000	11,300
Less: Zero bracket amount	2,300	3,000
Equals: EXCESS ITEMIZED DEDUCTIONS	9,700	8,300
AGI	60,000	61,900
Less: Exemption	1,000	1,600
Excess itemized deductions	9,700	8,300
Equals: TAXABLE INCOME	49,300	52,000
TAX	13,595*	12,264**
Marginal tax rate	45%	30%

* From 1984 law rate tables

** Taxable income less $3,000 zero bracket amount times 14 percent, plus surtax (12 percent of AGI from $25,000 to $37,500, and 16 percent of AGI in excess of $37,500).

MARRIED TAXPAYER #4

	1984 Law	Proposal
Income: Salary	60,000	60,000
Dividends	200	200
Less: Dividend exclusion	200	--
Two earner couple deduction	2,000	--
Plus: Employer paid health insurance	--	1,200
Employer paid life insurance	--	600
Equals: ADJUSTED GROSS INCOME	58,000	62,000
Itemized deductions:		
Mortage interest	4,800	4,800
Property taxes	2,000	2,000
Sales taxes	800	--
Income taxes	2,400	2,400
Charitable contributions	1,500	1,500
TOTAL	11,500	10,700
Less: Zero bracket amount	3,400	6,000
Equals: EXCESS ITEMIZED DEDUCTIONS	8,100	4,700
AGI	58,000	62,000
Less: Exemptions	4,000	5,200
Excess itemized deductions	8,100	4,700
Child care deduction	--	3,000
Equals: TAXABLE INCOME	45,900	49,100
TAX BEFORE CREDIT	9,810*	8,674**
Less Child care credit	600	--
Equals: TAX AFTER CREDIT	9,210	8,674
Marginal tax rate	38%	26%

* From 1984 law rate tables

** Taxable income less $6,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI over $40,000)

SINGLE TAXPAYER #5

	1984 Law	Proposal
Income: Salary	60,000	60,000
Long term capital gains	40,000	40,000
Interest and Dividends	20,000	20,000
TOTAL	120,000	120,000
Less: Capital gain exclusion	24,000	--
Dividend exclusion	100	--
Net interest exclusion	450	--
Plus: Employer paid health insurance	--	1,200
Employer paid life insurance	--	600
Equals: ADJUSTED GROSS INCOME	95,450	121,800
Itemized deductions:		
Mortgage interest	5,000	5,000
Other interest	5,000	2,500
Property tax	3,000	3,000
Sales tax	1,000	--
Income tax	7,500	7,500
Charity	5,000	5,000
TOTAL	26,500	23,000
Less: Zero bracket amount	2,300	3,000
Equals: Excess itemized deductions	24,200	20,000
AGI	94,450	121,800
Less: Exemption	1,000	1,600
Less: Excess itemized deductions	24,200	20,000
Equals: TAXABLE INCOME	70,250	100,200
TAX	23,291*	28,596**
Martingal tax rate: ordinary income	48%	30%
capital gains	19.2%	30%

* From 1984 law rate tables

** Taxable income less $3,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI from $25,000 to $37,500, and 16 percent of AGI in excess of $37,500)

MARRIED TAXPAYER #5

	1984 Law	Proposal
Income: Salary	60,000*	60,000*
Long term capital gains	40,000	40,000
Interest and dividends	20,000	20,000
TOTAL	120,000	120,000
Less: Capital gain exclusion	24,000	--
Dividend exclusion	200	--
2 earner deduction	2,000	--
Net interest exclusion	900	--
Plus: Employer paid health insurance	--	1,200
Employer paid life insurance	--	600
Equals: ADJUSTED GROSS INCOME	92,900	121,800
Itemized Deductions:		
Mortgage interest	5,000	5,000
Other interest	5,000	2,500
Property tax	3,000	3,000
Sales tax	1,200	--
Income tax	7,000	7,000
Charity	5,000	5,000
TOTAL	26,200	22,500
Less: Zero bracket amount	3,400	6,000
Equals: Excess Itemized Deduction	22,800	16,500
AGI	92,900	121,800
Less: Exemptions	4,000	5,200
Excess Itemized Deductions	22,800	16,500
Child care deduction	--	4,000
Equals: TAXABLE INCOME	66,100	96,100
TAX BEFORE CREDIT	17,730**	24,702***
Child care credit	800	--
TAX	16,930	24,702
Marginal tax rate: ordinary income	42%	30%
capital gains	16.8%	30%

* Assumed $40,000 earned by one spouse, $20,000 by the other

** From 1984 law rate tables

*** Taxable income less $6,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI from $40,000 to $65,000, and 16 percent of AGI in excess of $65,000)

SINGLE TAXPAYER #6

		1984 Law	Proposal
Income:	Salary	60,000	60,000
	Interest and Dividends	60,000	60,000
	TOTAL	120,000	120,000
Less:	Dividend exclusion	100	--
	Net interest exclusion	450	--
Plus:	Employer paid health insurance	--	1,200
	Employer paid life insurance	--	600
Equals:	ADJUSTED GROSS INCOME	119,450	121,800
Itemized deductions:			
	Mortgage interest	5,000	5,000
	Other interest	5,000	2,500
	Property tax	3,000	3,000
	Sales tax	1,000	--
	Income tax	7,500	7,500
	Charity	5,000	5,000
	TOTAL	26,500	23,000
Less:	Zero bracket amount	2,300	3,000
Equals:	Excess itemized deductions	24,200	20,000
AGI		119,450	121,800
Less:	Exemption	1,000	1,600
Less:	Excess itemized deductions	24,200	20,000
Equals:	TAXABLE INCOME	94,250	100,200
TAX		35,060*	28,596**
Marginal tax rate:	ordinary income	50%	30%
	capital gains	20%	30%

* From 1984 law rate tables

** Taxable income less $3,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI from $25,000 to $37,500 and 16 percent of AGI in excess of $37,500)

MARRIED TAXPAYER #6

	1984 Law	Proposal
Income: Salary	60,000*	60,000*
Interest and dividends	60,000	60,000
TOTAL	120,000	120,000
Less: Dividend exclusion	200	--
2 earner deduction	2,000	--
Net interest exclusion	900	--
Plus: Employer paid health insurance	--	1,200
Employer paid life insurance	--	600
Equals: ADJUSTED GROSS INCOME	116,900	121,800
Itemized deductions:		
Mortgage interest	5,000	5,000
Other interest	5,000	2,500
Property tax	3,000	3,000
Sales tax	1,200	--
Income tax	7,000	7,000
Charity	5,000	5,000
TOTAL	26,200	22,500
Less: Zero bracket amount	3,400	6,000
Equals: EXCESS ITEMIZED DEDUCTION	22,800	16,500
AGI	116,900	121,800
Less: Exemptions	4,000	5,200
Excess Itemized Deductions	22,800	16,500
Child care deduction	--	4,000
Equals: TAXABLE INCOME	90,100	96,100
TAX BEFORE CREDIT	27,945**	24,702***
Child care credit	800	--
TAX	27,145	24,702
Marginal tax rate: ordinary income	45%	28%
capital gains	18%	28%

* Assumed $40,000 earned by one spouse, $20,000 by the other

** From 1984 law rate tables

*** Taxable income less $6,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI from $40,000 to $65,000, and 16 percent of AGI in excess of $65,000)

MARRIED TAXPAYER #7

		1984 Law	Proposal
Income:	Salary	200,000*	200,000*
	Long term capital gain	400,000	400,000
	Interest and dividends	400,000	400,000
	TOTAL	1,000,000	1,000,000
Less:	Capital Gain exclusion	240,000	--
	Dividend exclusion	200	--
	2 earner deduction	3,000	--
	Net interest exclusion	900	--
Plus:	Employer paid health insurance	--	1,200
	Employer paid life insurance	--	2,000
Equals:	ADJUSTED GROSS INCOME	755,900	1,003,200
Itemized deductions:			
	Mortgage interest	10,000	10,000
	Other interest	100,000	50,000
	Property tax	10,000	10,000
	Sales tax	4,000	--
	Income tax	100,000	100,000
	Charity	50,000	50,000
	TOTAL	274,000	220,000
Less:	Zero bracket amount	3,400	6,000
Equals:	EXCESS ITEMIZED DEDUCTIONS	270,600	214,000
AGI		755,900	1,003,200
Less:	Exemptions	4,000	5,200
	Excess itemized deductions	270,600	214,000
	Child care deduction	--	4,800
Equals:	TAXABLE INCOME	481,300	779,200
TAX BEFORE CREDIT		222,050**	261,360***
Child care credit		960	--
TAX AFTER CREDIT		221,090	261,360
Marginal tax rate:	Ordinary income	50%	30%
	Capital gains	20%	30%

* Assumed at least $30,000 earned by lesser earning spouse

** From 1984 law rate tables

*** Taxable income less $6,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI from $40,000 to $65,000, and 16 percent of AGI in excess of $65,000)

MARRIED TAXPAYER #8

		1984 Law	Proposal
Income:	Salary	200,000*	200,000*
	Interest and Dividends	800,000	800,000
	TOTAL	1,000,000	1,000,000
Less:	Dividend exclusion	200	--
	Two earner deduction	3,000	--
	Net interest exclusion	900	--
Plus:	Employer paid health insurance	--	1,200
	Employer paid life insurance	--	2,000
Equals:	ADJUSTED GROSS INCOME	995,900	1,003,200
Itemized deductions:			
	Mortgage interest	10,000	10,000
	Other interest	100,000	50,000
	Property taxes	10,000	10,000
	Sales taxes	4,000	--
	Income taxes	100,000	100,000
	Charitable contributions	50,000	50,000
	TOTAL	274,150	220,000
Less:	Zero bracket amount	3,400	6,000
Equals:	EXCESS ITEMIZED DEDUCTIONS	270,600	214,000
AGI		995,900	1,003,200
Less:	Exemptions	4,000	5,200
	Excess itemized deductions	270,600	214,000
	Child care deduction	--	4,800
Equals:	TAXABLE INCOME	721,300	779,200
TAX BEFORE CREDIT		342,050**	261,360***
Child care credit		960	--
TAX AFTER CREDIT		341,090	261,360
Marginal tax rate:	Ordinary income	50%	30%
	Capital gains	20%	30%

* Assumed at least $30,000 earned by lesser earning spouse

** From 1984 law rate tables

*** Taxable income less $6,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI from $40,000 to $65,000 and 16 percent of AGI in excess of $65,000)

MARRIED TAXPAYER #9

		1984 Law	Proposal
Income:	Salary	200,000*	200,000*
	Interest and dividends	800,000	800,000
	Oil and gas partnership revenues	100,000	100,000
	Less: Intangible drilling costs	1,000,000	142,857
	Depletion	65,000	14,286
	TOTAL	35,000	942,857
Less:	Dividend exclusion	200	--
	Two earner deduction	3,000	--
	Net interest exclusion	900	--
Plus:	Employer paid health insurance	--	1,200
	Employer paid life insurance	--	2,000
Equals:	ADJUSTED GROSS INCOME	30,900	946,057
Itemized deductions:			
	Mortgage interest	10,000	10,000
	Other interest	100,000	50,000
	Property taxes	10,000	10,000
	Sales taxes	4,000	--
	Income taxes	100,000	100,000
	Charitable contributions	50,000	50,000
	TOTAL	274,000	220,000
	Less: Zero bracket amount	3,400	6,000
	Equals: EXCESS ITEMIZED DEDUCTIONS	270,600	214,000
AGI		30,900	946,057
Less:	Exemptions	4,000	5,200
	Excess itemized deductions	270,600	214,000
	Child care deduction	--	4,800
Equals:	TAXABLE INCOME	-0-	722,057
TAX BEFORE CREDIT		-0-**	244,217***
Child care credit		960	--
TAX AFTER CREDIT		-0-	244,217
MINIMUM TAX		158,000	--
TOTAL TAX		158,000	244,217
Marginal tax rate		20%	30%

* Assumes at least $30,000 earned by lesser earning spouse

** From 1984 law rate tables

*** Taxable income less $6,000 zero bracket amount times 14 percent tax rate, plus surtax (12 percent of AGI from $40,000 to $65,000 and 16 percent of AGI in excess of $65,000)

MARRIED TAXPAYER #10

	1984 Law	Proposal
Income: Salary	30,000*	30,000*
Less: Two earner deduction	1,000	--
Plus: Employer paid health insurance	--	1,200
Employer paid life insurance	--	300
Equals: ADJUSTED GROSS INCOME	29,000	31,500
Itemized deductions:		
Mortgage interest	5,000	5,000
Property taxes	1,500	1,500
Sales taxes	400	--
Income taxes	1,000	1,000
Charitable contributions	500	500
TOTAL	8,400	8,000
Less: Zero bracket amount	3,400	6,000
Equals: EXCESS ITEMIZED DEDUCTIONS	5,000	2,000
AGI	29,000	30,500
Less: Exemptions	4,000	5,200
Excess itemized deductions	5,000	2,000
Child care deduction	--	2,000
Equals: TAXABLE INCOME	20,000	22,300
TAX BEFORE CREDIT	2,461**	2,282***
Less: Child care credit	400	--
Equals: TAX AFTER CREDIT	2,061	2,282
Marginal tax rate	18%	.14%

* Assumed $20,000 earned by one spouse, $10,000 by the other

** From 1984 law rate tables

*** Taxable income less $6,000 zero bracket amount times 14 percent tax rate

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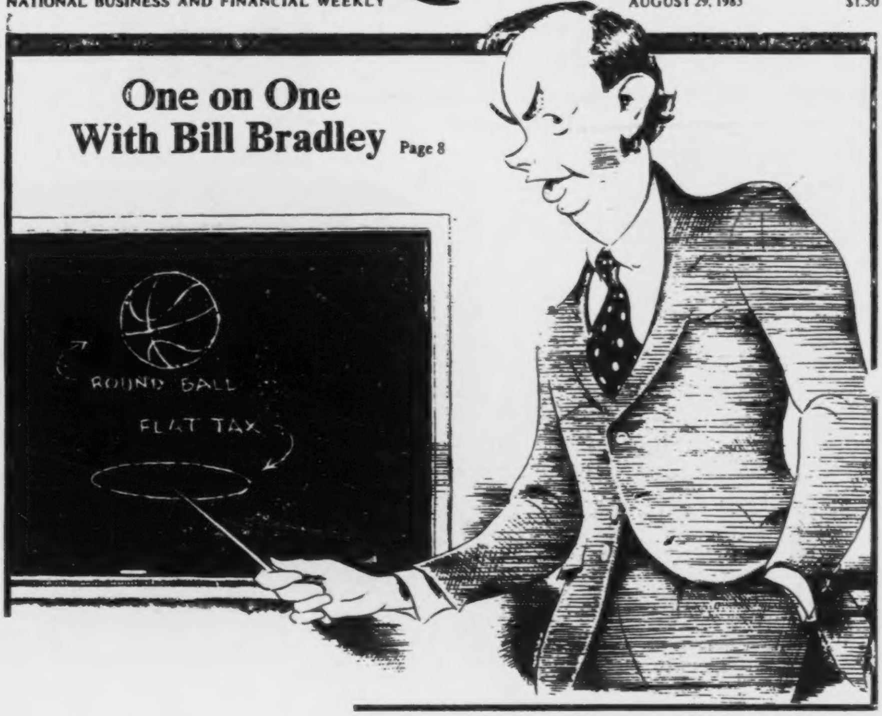

ROUND BALL
FLAT TAX

One on One With Bill Bradley Page 8

Appreciating Dollar Bill

Senator Bradley Scores Points With a "Fair Tax"

By THOMAS G DONLAN

WASHINGTON—Bill Bradley ran up against Reaganomics two years before most of his fellow Democrats in the Senate. That helps to explain why he's now sponsoring tax-reform legislation that could become the Democrats' answer to Ronald Reagan in the 1984 campaign.

In 1981, when Reagan steamrolled the Congress with tax cuts, Bradley, who had defeated a tax-cutting former Reagan aide in 1978, stood alone in the Senate Finance Committee against the President. Other Democrats accepted Reagan's mandate, or at least feared to challenge it. Bradley was on the short end of a 19-1 vote in the committee and a 92-4 vote on the Senate floor.

This summer, however, Bradley sounds a little like a born-again supply-sider as he goes around the country promoting his new tax reform proposal, which he calls "The Fair Tax." It has something for everyone: some investment incentives; some simplification; some loophole-closing; some lower rates. The measure (a companion bill was introduced in the House by Democratic Rep. Richard Gephardt of Missouri) would work like this:

- Every individual would pay a basic 14% tax on income and capital gains. There would be larger personal exemptions and standard deductions. Then individuals with adjusted incomes over $25,000 and couples making more than $40,000—one out of five taxpayers—would pay a 12% surtax on the excess. On income over $37,500 for single taxpayers and $65,000 for couples, the surtax would rise to 16%. Thus, there would be three marginal tax rates: 14%, 26% and 30%.
- Nearly every deduction and tax credit would be repealed, except those that are most politically popular, such as for mortgage interest, business expenses, charitable contributions, state income taxes, local property taxes, IRA and Keogh plan contributions, and medical expenses. But even these would be devalued, for they would rate as deductions only against the basic 14% rate, not against the higher marginal rate as the present tax code allows.
- Corporations would pay a flat 30% on income less depreciation. Gone would be investment tax credits, depletion allowances, safe-harbor leases, fancy expensing and special depreciation schedules for favored investments. Depreciation would be "simplified," and the accelerated depreciation so favorable to business that was enacted in 1981 would be repealed.

It's an ambitious program, one that would antagonize virtually every special interest in the country, and Bradley doesn't expect it to get serious congressional attention until 1985—after the next presidential election. But it would lower taxes for 70% of Americans and penalize most of those taxpayers who make use of sophisticated tax shelters and tax avoidance schemes.

Bradley points to public opinion polls that show a large majority of Americans believe that other people in their income class are using loopholes to pay less tax. The people don't like that, according to the pollsters. And the plan's cosponsor, Gephardt, says they are right: "People think that our government reflects the special interests and that our tax system does likewise."

Bradley feels mistrust of the tax system, as much as high rates, is responsible for the flourishing of the underground economy, which the Internal Revenue Service estimates will cost the Treasury $100 billion in lost income taxes this year.

The Bradley-Gephardt "Fair Tax" is designed to change that. Politically, its most important feature is that it does not affect the progressivity of the present tax system. Bradley's staff tinkered with rates, deductions and personal exemptions through hundreds of runs on the Joint Taxation Committee's computer model. They didn't stop until they had each income class in the present system contributing the same percentage of total tax revenue that it does now.

"We are just as progressive with three brackets as the current system is with 14," Bradley says proudly. He figures that previous tax reform efforts foundered on the definition of reform. Trying to make the rich pay more or the poor pay less leads to no change at all, he contends.

What's unfair about the current system, he says, is that "it's loaded down with special preferences and loopholes that allow some people to reduce their taxes at the expense of everybody else having to pay high rates." And he adds: "There is no free lunch in tax policy. You can cut rates but if you don't close loopholes, you increase deficits. Therefore, you should do them simultaneously."

Bradley's program is a nice political brew of supply-side economics, conservative flat tax notions and liberal populism. Although destined to become a partisan Democratic plan—maybe a plank in the party's '84 platform—Bradley, without a trace of sarcasm in his voice, argues: "There is no reason why Republicans shouldn't endorse it because it is consistent with both the 1981 and 1982 [tax] acts: 1981 cut rates, 1982 closed loopholes." He ignores the fact that both laws split the GOP.

Bradley's experience with the politics of tax-cutting began in 1978, when he turned his fame as a New York Knickerbocker basketball star into a political asset. The neophyte New Jersey politician ran for the Senate against Jeffrey Bell, who had worked in the 1976 Reagan campaign. Bell made tax-cutting practically his sole issue, and he upset the liberal Republican incumbent, Clifford P. Case, in the primary. (Case also ran practically no campaign—his overconfidence led one politician to say: "Case thinks he's Civil Service.")

When it came to the general election, Bradley was concerned enough about the appeal of Bell's tax-cut plan to consult Sen. Russell Long (D, La.), the Senate's archdeacon of taxation. Long advised him to counter with a one-shot tax-cut proposal, instead of Kemp-Roth's three years of tax cuts and indexation forever.

Bradley took Long's advice, although he never seemed comfortable with a watered-down, me-too approach. His television advertising producer, Michael Kaye, was less diffident. One of Bradley's ads showed crutches and wheelchairs and blackboards and hospital beds and all the good things that government pays for being tossed on an ugly trash heap. Bradley stood in front of the pile and said Republican tax cuts would mean the government couldn't afford these things. Tip O'Neill would have loved it.

By nearly a quarter-million votes, New Jersey sent Bradley to Washington. He was just 35, the Senate's youngest member, and he had never before held office, but he captured seats on two of the most powerful committees—Finance and Energy. Bradley says the campaign didn't galvanize his interest in taxes, but that he'd always been interested in them "since I had paid so much." It's a remark characteristic of a man whose teammates called him "Dollar Bill" because he was so tight with a buck and because he had a contract that paid him several hundred thousand dollars over a few years, at a time when such payouts weren't all that common.

In his first couple of years in the Senate, Bradley concentrated on energy issues. He worked up legislation for federal sponsorship of solar energy, energy from garbage and home energy conservation, but they were among the first casualties of President Reagan's budget-cutting in 1981. He worked tirelessly, and successfully, for the windfall-profits tax on oil. He went against President Carter and President Reagan in urging more rapid filling of the Strategic Petroleum Reserve, something he favors even more now that the price of OPEC oil is down.

But he and his staff were working on tax reforms, too. Bradley started talking about a first version of his package last summer. In September of last year, he insinuated it onto the agenda of a Senate Finance Committee hearing on flat-rate taxes, where many witnesses gave the idea of a simple progressive tax better reviews than the flat-tax concept. Then Bradley and Gephardt did a grand announcement with speeches and detailed proposals last April 14—a date chosen, of course, to maximize interest in taxes. Finally, a bill went into the hopper two months ago.

As noted, Bradley doesn't expect much action on the bill until 1985. But, a determined man, Bradley plans his moves long in advance. He says he made up his mind to be in the Senate on the day in 1964 when he watched from the gallery as that body adopted the Civil Rights Act. He once said he decided to become a professional basketball player in part because it might help him get the name recognition and goodwill he'd need to win elections. Though he never discusses any ambition beyond winning re-election in 1984, he's on the short list journalists and politicians keep in the back of their minds as possible presidential candidates. (Bradley says he's not a contender in '84 and also rules out running for vice president.)

Basically, he's where Walter Mondale and Gary Hart and John Glenn were not so many years ago. Perhaps all he needs is a good issue—like tax reform.

Although he doesn't play basketball, or do the kind of exercise he would need to end his worries about his weight, Bradley still leads a life reminiscent of the title of his 1976 book on pro basketball, *Life on the Run*. He runs a perpetual campaign, which he calls "a style of responsiveness." He works hard for New Jersey's share of the pork barrel, winning on such matters as keeping the Army training center at Fort Dix open, getting more funding for mass transit, securing a VHF television license for the Garden State and more. And he spends two or three days of each week in the state—and not just because his family usually is in residence near Montclair State College, where his wife, Ernestine, works as a professor of comparative literature. (The Bradleys have a nine-year-old daughter.)

"We have an aggressive conference schedule of high school seminars, small business and export meetings, things on government procurement [illegible] health care," says Bradley, of[illegible] a longer list. "And we have town meetings. And we also have what I call walking town meetings, where I go where people don't expect to see me and I ask them, 'What's on your mind?' "

Bradley probably will face only token opposition in next year's Senate race. Nevertheless, he's raised $1.6 million for it already. "You have your game plan and you execute it whoever your opponent is," he says.

Bradley's game plan is to stay on the run. He says there's more to it than just campaigning: "In Washington, you get caught up with the substance and with the procedure in the Senate, and then you come back to the town meeting or a walk along the shore or at a commuter stop. People really give you the reasons in human terms for your representation."

We caught up with Bill Bradley one day a couple of weeks ago to talk about taxes and the economy. He never actually ran, but his long stride gives him, at least, a fast walk. He started with a radio interview, then a talk to a community college group. Then a short walk with some peace marchers, a visit to the editorial board of a local newspaper, and an appearance at a fund-raising dinner for one of New Jersey's 21 county Democratic organizations. In the car, he was looking for some time to squeeze in some kind of a "meet-and-greet" event at a train station or a shopping mall.

Q: One of the important elements of your Fair Tax is not to disturb the existing progressivity of the system, right? Is that a fair tax?

A: Well, the decision we took was to look at the income tax system and try to design a system that was simpler with the lowest possible rates.

"The Treasury is saying deficits make no difference whatsoever. I find that to be slightly ludicrous."

Q: Do you think lower rates would automatically improve the economy?

A: Yes. Essentially a short way of saying this is that supply-side economics was right in its conclusion on that lower rates do stimulate work, savings and investment. Where it went wrong, I think, was in saying that if you cut tax rates you will have more revenue—the famous statement by the President in September 1980 that we will cut taxes and from the increased revenues that flow from the reduced taxes we will finance our defense build-up. That was the Achilles heel of supply-side.

Q: Do you have any expectation that we are going to get a supply-side boom now?

A: No.

Q: Well, what's your version of supply-side?

A: Lower rates stimulate work, savings and investment. If you are a person who is considering working an hour of overtime, and you know you are only going to keep 50 cents on the dollar, you are less likely to do that than if you are going to keep 70 cents. And if you are in under $40,000 as a couple, you are going to keep 86 cents of every overtime dollar. You are going to work more.

Q: What about stimulating the economy to provide the overtime hours to be worked in the first place?

A: Well, I happen to think that the broad general effect of lower tax rates will contribute to economic growth. I happen to think that the tax system as such does not create economic growth or jobs. I think the private sector creates economic growth and jobs.

Q: You won't get an argument here.

A: And I think that the tax system is like a hurdle that the private sector has to get over to go on about creating the jobs. The goal of the tax system should be as low a hurdle as possible.

Q: Do you see any impact on unemployment from lower taxes?

A: You have to keep in mind that the tax system affects our domestic economy but our domestic economy is integrally related to an international economy. Full employment, defined as, you know, 5% unemployment, will not be achieved unless we compete effectively in the world economy. But to compete effectively, you have to have the most efficient allocation of resources. And how do we get that? Which is the more efficient allocator of resources, the Senate Finance Committee and the House Ways and Means Committee, using various provisions of eight tax bills in the last 10 years, or the market? I happen to think that the market is a more efficient allocator of resources. Therefore you try to make the tax system as neutral as possible by getting tax rates down, so the hurdle is as low as possible. Then investment flows to those industries that are producing the goods that have real value in the marketplace.

Q: Congressional committees have been allocating resources and favoring one form of investment over another for a long time. Your bill has a long list of things that would be repealed—everything from special treatment for oil wells to special treatment for adopting children.

A: Drop tax rates and create a more hospitable general environment, the reason for special provisions decreases.

Q: You'd rather drop rates generally?

A: If you drop those tax rates and create a more hospitable general environment, the reason for those special provisions decreases.

Q: Let's scrutinize the Fair Tax a bit. If it doesn't redistribute income, what would be the source of its support?

A: Because within categories of income, there will be a shift in tax burden and you will find a great number of working families, primarily wage earners, who will be paying less tax: 70% paying less tax and 30% paying more. Since 70 is bigger than 30, more people will be benefiting.

Q: Okay. In general the Fair Tax, although it would reduce all the tax rates, would raise the relative rate of taxation on capital and on investment relative to salary income. They'd be the same, instead of capital rates lower.

A: You have to look at it more carefully, because on interest income, it drops from [a maximum of] 50% to 30% and on dividend income it drops from 50 to 30. On wage income it drops from 50 to 30. On capital gains, it goes from 20 to 30. But at the same time, there is no artificial holding period.

Q: Do you think that's a fair exchange for a stock market investor?

A: I think that, overall, the Fair Tax is pro-investment and it is pro-economic growth. And I think you will find a lot of firms having larger after-tax profits and therefore there will be a big stimulus in those growth companies.

Q: How would the Fair Tax improve the prospects for growth companies from which investors normally expect primarily capital gains?

A: Right now a lot of growth companies are paying 42% and 43% corporate tax. Under the Fair Tax they would be paying 30% corporate tax, which means

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APPRECIATING DOLLAR BILL

Continued from Page 9

they would have a lot more after-tax income and this would be reflected in their share prices.

Q: Being new companies they do not have a lot of corporate tax shelters?

A: And because if they have a new mouse trap they should be rewarded and those who invest in those growth companies should achieve a generous return.

Q: You think it would balance out: the difference between an investor's paying a higher capital gains rate on the appreciation of the shares vs. the shares' appreciating more because they would have more after-tax income?

A: Yes, and then you also combine that with the fact that the tax system would recognize the velocity of financial decision-making and wouldn't penalize people who shift their portfolios monthly or every six months. In a world where you have economic events happening very rapidly, that is a very essential part of a tax system.

Q: One reason for giving capital gains a lower tax rate is that some capital gains are illusory, they come from inflation. The Fair Tax might not be fair with inflation.

A: If you hypothesize rampant inflation, yes, and if inflation went up at a very high rate you might want to consider indexing the basis. Last year, I voted for that.

Q: How about indexing the tax brackets? That's one important part of President Reagan's program to make taxes fairer by eliminating the effect of inflation. Would your tax system be indexed?

A: No.

Q: Why not?

A: Why not?

Q: Yes, why not? Wouldn't bracket creep still be a problem?

A: Much, much less a problem with three rates instead of 14. Also, you can't use the tax system to fight inflation. You must have a macroeconomic policy that fights inflation.

Q: Incidentally, what's your position on repeal of indexing in the present system?

A: I haven't decided.

Q: Did you vote for indexing originally?

A: I voted against it initially, on the grounds that if you inoculate everyone against inflation, then inflation is easier to absorb. And I think that is probably not appropriate. That's not advisable.

Q: On the other hand, lack of indexing is what inoculated government spending from inflation because bracket creep brought in

A: Yes. I mean. I understand that.

Q: If a Democratic proposal to repeal President Reagan's indexing should make it to the floor, what would be your inclination?

A: I don't know. I'd have to think about it. It depends on what you are going to do with the other indexing on the government spending side. There are some Republicans who are advocating eliminating a big part of the indexing on the tax side in exchange for eliminating some of the indexing on the entitlements side. You know, it depends on what the context is in which something comes up. I can't say right now what would happen.

Q: It looks like the flat-tax movement reached a peak last year with hearings in September. Your Fair Tax was included in those hearings even though it's not a flat tax, just a kind of second cousin because it's flatter than the present system. Yet your plan has survived.

A: Well, the people who came to the hearing said that the Fair Tax was the only idea that made any sense. From former IRS Commissioners to Common Cause to businesses, they endorsed our idea. . . . Others were summarily dispensed with as gimmicks or highly unfair.

Q: Unfair in what sense?

A: Transferring the tax burden from upper-income to middle- and lower-income people.

Q: Okay. What do you think is going to happen with the economy and inflation?

A: Well, the recovery is like a three-stage rocket. The first stage is consumption spending, and indeed, that has increased. People are buying cars and clothes and houses. That has been one of the major components of the recovery to date. The second stage is inventory buildup and indeed, companies are ordering those goods to resupply their shelves and their showrooms. So that is a positive sign. The third element, which is absolutely critical, is whether we are going to get increased investment. That depends on whether firms perceive that they should order new equipment now—and that is very interest rate sensitive. So the answer as to whether we are going to have a three-stage rocket or a two-stage rocket that fizzles is dependent on where interest rates are going.

Q: A lot of people would like to know that.

A: My own sense is that interest rates could be headed up. I don't think they are headed toward 20%, but they could be headed up sufficiently to cause a real dropoff in the economy in the next couple of months. I hope that we don't have a dropoff. I hope we have a robust recovery and that we continue into a long-term growth pattern.

Q: But?

A: I have some real reservations that that will occur, given the $200-billion budget deficits that are out there. Right now, the bulk of the government paper that is being put out—there is a big chunk of it that isn't being bought by people out there and is being taken by financial institutions. And that ultimately gets back to the Federal Reserve. It has gone from the Treasury to the market to the Federal Reserve.

Q: Isn't Congress supposed to do something about deficits?

A: There will not be a significant reduction of those deficits if the White House doesn't play in that game. And if the White House says that the only way we are going to be able to reduce the deficit is to cut nondefense spending, and it is unwilling to admit that you also have to do something on the revenue side or with defense spending, then I think you have the components for a paralysis and higher interest rates.

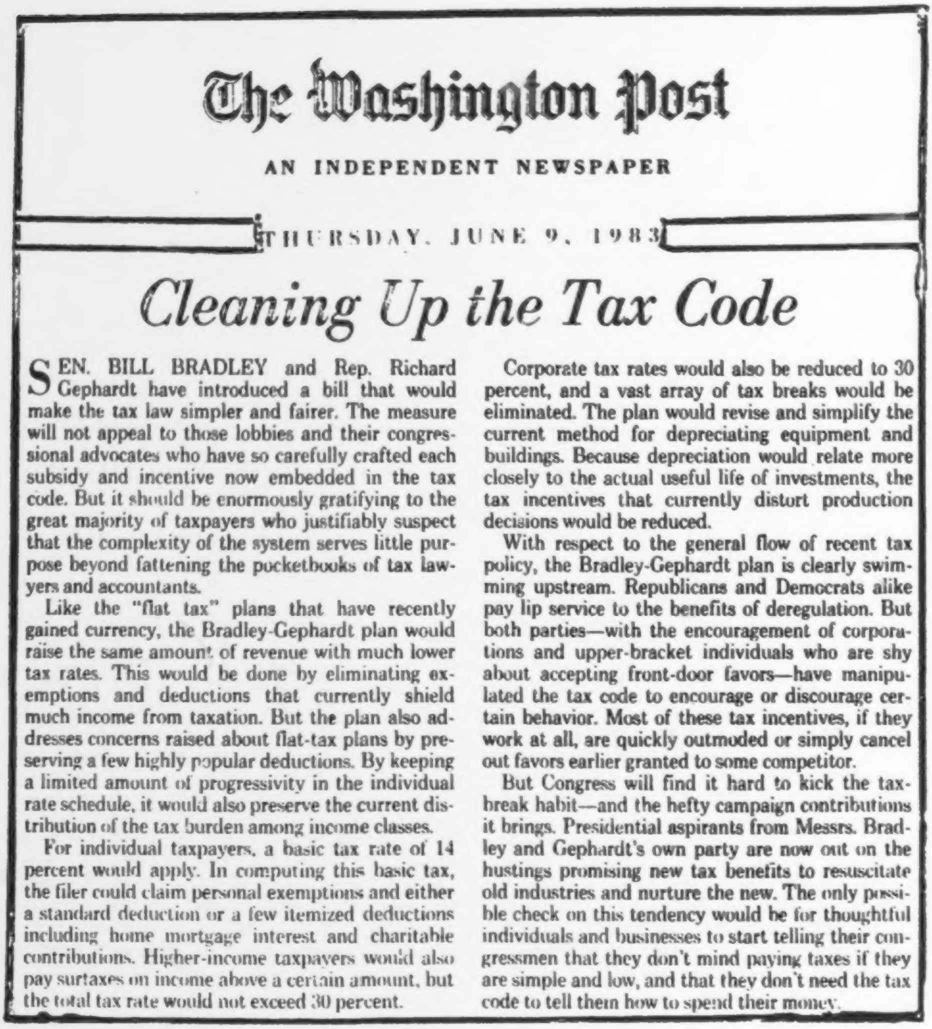
Q: You're making tax reform sound easy.

A: One of the real ironies is that we had an Administration taking office saying that the cause of inflation was deficits. Now we have the biggest deficits in history and they are saying it is unrelated to inflation or anything. The Treasury Department is saying essentially deficits make no difference whatsoever. We can forever live beyond our means. I find that to be slightly ludicrous.

Q: But at least inflation is down.

A: Inflation is down, but the reason it is down is not because of a very ingenious macroeconomic policy. Inflation is down for the same reason it has always gone down in the depths of a recession, which is you have an underutilization of plant and capacity, a lot of people out of work. In addition, you've had a couple of very lucky breaks, a drop in the oil market and abundant harvests.

Q: Thanks, Bill. Maybe we'll stay lucky until we get a new tax system. ■



The Washington Post

AN INDEPENDENT NEWSPAPER

THURSDAY, JUNE 9, 1983

Cleaning Up the Tax Code

SEN. BILL BRADLEY and Rep. Richard Gephardt have introduced a bill that would make the tax law simpler and fairer. The measure will not appeal to those lobbies and their congressional advocates who have so carefully crafted each subsidy and incentive now embedded in the tax code. But it should be enormously gratifying to the great majority of taxpayers who justifiably suspect that the complexity of the system serves little purpose beyond fattening the pocketbooks of tax lawyers and accountants.

Like the "flat tax" plans that have recently gained currency, the Bradley-Gephardt plan would raise the same amount of revenue with much lower tax rates. This would be done by eliminating exemptions and deductions that currently shield much income from taxation. But the plan also addresses concerns raised about flat-tax plans by preserving a few highly popular deductions. By keeping a limited amount of progressivity in the individual rate schedule, it would also preserve the current distribution of the tax burden among income classes.

For individual taxpayers, a basic tax rate of 14 percent would apply. In computing this basic tax, the filer could claim personal exemptions and either a standard deduction or a few itemized deductions including home mortgage interest and charitable contributions. Higher-income taxpayers would also pay surtaxes on income above a certain amount, but the total tax rate would not exceed 30 percent.

Corporate tax rates would also be reduced to 30 percent, and a vast array of tax breaks would be eliminated. The plan would revise and simplify the current method for depreciating equipment and buildings. Because depreciation would relate more closely to the actual useful life of investments, the tax incentives that currently distort production decisions would be reduced.

With respect to the general flow of recent tax policy, the Bradley-Gephardt plan is clearly swimming upstream. Republicans and Democrats alike pay lip service to the benefits of deregulation. But both parties—with the encouragement of corporations and upper-bracket individuals who are shy about accepting front-door favors—have manipulated the tax code to encourage or discourage certain behavior. Most of these tax incentives, if they work at all, are quickly outmoded or simply cancel out favors earlier granted to some competitor.

But Congress will find it hard to kick the tax-break habit—and the hefty campaign contributions it brings. Presidential aspirants from Messrs. Bradley and Gephardt's own party are now out on the hustings promising new tax benefits to resuscitate old industries and nurture the new. The only possible check on this tendency would be for thoughtful individuals and businesses to start telling their congressmen that they don't mind paying taxes if they are simple and low, and that they don't need the tax code to tell them how to spend their money.

THE WALL STREET JOURNAL, TUESDAY, JULY 12, 1983

A Flat Tax Can Help Growth Firms

By HARRY A. JACOBS JR.

The nation's tax code is a crazy quilt, patched together with investment-distorting special-interest provisions and held up by marginal rates that are too high.

We can promote investment without these inefficiencies if we simplify our tax system—by eliminating most tax preferences and by reducing marginal rates on all income.

Over many years, for example, we have taxed long-term capital gains at lower rates than ordinary income to spur private investment. That made some sense in a tax system with 70% or 50% marginal tax rates. But with rates cut drastically for everyone, special provisions such as the capital gains exclusion can be eliminated on sound investment grounds. There are several reasons this is so.

First, suppose the top corporate rate dropped from 46% to about 30%, as in the Bradley-Gephardt bill. Investors would profit because a company's net income would increase. This would generate potentially greater appreciation in the value of a concern's stock than is possible under current law.

This is especially important for young, high-technology or other venture-capital companies. Typically, they lose money early on, pay no dividends, and receive little help from special tax provisions. If all goes well, they eventually turn the corner and their shares rise in value. That's why most people have concluded that a low capital gains tax is crucial for venture capital.

But the corporate tax is an important factor, too. Venture-capital stock appreciates when the company's expected profits increase. Since most successful start-up companies will pay close to the 46% maximum corporate rate, lowering the rate to around 30% would boost the payoff to venture capital by increasing after-tax earnings. It would keep investment flowing toward these firms.

Second, if there were a parallel drop in the individual tax rate from 50% to 30%, shareowners would pay less tax on dividends. Since some substantial part of a stock's price is based on the expectation of a future stream of dividends, a reduced tax on dividends could be a powerful factor in improving the share values of young and mature companies alike.

Third, bondholders would benefit because the top rate on interest income would be lower. Also, corporations would borrow less for relatively marginal purposes because the interest-expense deduction would be less valuable. In general, both the lower tax rates and the more prudent borrowing policies would raise the national pool of savings.

Fourth, if the distinction between short-term and long-term capital gains were eliminated, investors would be free to make decisions without worrying about the calendar. And should an investor want to realize a gain in less than the present one-year holding period, the tax bite would be far smaller. In an increasingly volatile economic era, the need for more frequent repositioning of assets without major tax penalty is very real.

Some people believe that taxing investment income at a low uniform rate would discourage risk-taking. That is unlikely. Instead, it is more probable that the greater pool of savings would drive interest rates down and funds would switch from debt to equity. Over time, corporations would have a larger equity base and would be in a better position to withstand recessions. This is especially critical for small or rapidly growing companies.

In the final analysis, a low-rate, broadly based income tax would let investors make decisions on economic grounds, not tax gimmicks. That would strongly enhance capital formation and improve the overall investment climate. With more saving and less non-essential borrowing, with greater tax neutrality and fewer tax-induced distortions, funds would move into the most productive investment markets. The results would not only be pro-investor, but pro-economy as well.

Mr. Jacobs is chairman of Prudential-Bache Securities Inc.

MAJOR TAX REFORM PROPOSALS

Item	Kemp-Kasten "FAST"	Bradley-Gephardt "Fair"	Present Law "Present"
	INDIVIDUAL INCOME TAX		
Indexing Retained	Yes	No	Yes
	Marginal Tax Brackets Single Persons		
$000-2300	0%	0%	0%
2300-2600	0	0	11
2600-3000	20	0	11
3000-3400	20	14	11
3400-4100	20	14	12
4100-4400	20	14	12
4400-6000	20	14	14
6000-6500	20	14	14
6500-8500	20	14	15
8500-10,800	20	14	15
10,800-12,900	20	14	18
12,900-15,000	20	14	20
15,000-16,000	20	14	23
16,000-20,000	20	14	23
20,000-23,500	20	14	26
23,500-25,000	20	14	30
25,000-28,800	20	26	30
28,800-30,000	20	25	30
30,000-34,100	20	26	34
34,100-37,500	20	26	38
37,500-39,300	20	30	38
39,300-40,000	28	30	39
40,000-41,500	28	30	39
41,500-55,300	28	30	42
55,300-81,800	28	30	48
81,800-102,180	28	30	50
102,180 and above	25	30	50
	Married Persons		
$0-3400	0%	0%	0%
3400-3500	0	0	11
3500-5500	20	0	11
5500-6000	20	0	12
6000-6700	20	14	12
6700-7600	20	14	12
7600-10,000	20	14	14
10,000-11,900	20	14	14
11,900-16,000	20	14	16
16,000-20,200	20	14	18
20,200-24,000	20	14	18
24,000-24,600	20	14	22
24,600-26,000	20	14	25
26,000-29,900	20	14	25
29,900-35,200	20	14	28
35,200-40,000	20	14	33
40,000-45,000	20	26	33

45,000-45,800	20	26	33
45,800-58,950	23	26	38
58,950-60,000	28	26	38
60,000-65,000	29	26	42
65,000-85,600	28	30	42
85,600-109,400	28	30	45
109,400-153,270	28	30	49
153,270-162,400	25	30	49
162,400 and above	25	30	50

EXEMPTIONS

Self,Spouse	2000	1500(.14)	1000
Dependents	2000	1000(.14)	1000
Elderly	No Extra	1000(.14)	1000
Blind	No Extra	1000(.14)	1000

PERSONAL DEDUCTIONS

Mortgage Interest	Yes	Yes(.14)	Yes
Other Personal Interest	Yes	No	Yes
Property Taxes	Yes	Yes(.14)	Yes
Income Taxes	No	Yes(.14)	Yes
Other Local Taxes	No	No	Yes
Charitable Contributions	Yes	Yes(.14)	Yes
Medical Expenses	Yes(10%AGI)	Yes(10%AGI,.14)	Yes(5%AGI)
Two Earner Deduction	Repealed	Repealed	Yes(10% lower salary)

OTHER INDIVIDUAL

Income Averaging	Repealed	Repealed	Yes

RETIREMENT

IRA Earnings	Deferred Tax	Deferred Tax	Deferred Tax
IRA Deductions	Yes	Yes	Yes
Keogh Earnings	Deferred Tax	Deferred Tax	Deferred Tax
Keogh Contributions	Yes	Yes	Yes
Corporate Pensions	Deferred Tax	Limited	Deferred Tax
Social Security	Excluded	Excluded	Excluded

INVESTMENTS

Maximum Capital Gains Rate	19%,then 25%	30%	20%
Capital Gains Exclusion	25%, then 0%	0%	50%
Capital Basis	Indexed	Not Indexed	Not Indexed
Dividend Exclusion	$0	$0	$100/200
Homeowner Exclusion	Yes	Partial	Yes
General Obligation Municipal Bonds	Not Taxed	Not Taxed	Not Taxed
Other Municipal Bonds	Taxed	Taxed	Not Taxed
Alternative Minimum Tax	Retained	Repealed	Yes

DEPRECIATION

Investment Credit	None	None	6-10%
Depreciation Method	ACRS	Modified ADR	ACRS

Asset Life

ADR Midpoint Life			
0-5.0	3	4	3
5.5-8.5	5	6	5
9.0-14.5	5	10	5
15-24	10	18	10
25-35	15	28	15
35 and over	15	40	15
Declining Balance Percentage	NA	250%	NA

LOWER INCOME

Earned Income Credit	Yes,Modified	Retained	Yes
Child Care Credit	Repealed	Ded.(.14)	Yes
Unemployment Compensation	Taxed	Taxed	Taxed over $12,000
Worker's Compensation	Not Taxed	Not Taxed	Not Taxed

EMPLOYER PROVIDED FRINGE BENEFITS

Health Insurance	Benefits Taxed	Included	Excluded
Life Insurance	Excluded	Included	Excluded
Other Statutory	Included	Included	Included

MAJOR TAX REFORM PROPOSALS

Item	Kemp-Kasten "FAST"	Bradley-Gephardt "Fair"	Present Law "Present"
CORPORATE INCOME TAX			
Basic Rate	30%	30%	46%
Capital Gains Rate	20%	30%	28%
Reduced rates, first $100,000	15% to $50,000	Repealed	Retained
DEPRECIATION			
Depreciation	ACRS	Modified ADR	ACRS
Investment Tax Credit	None	None	6-10%
NATURAL RESOURCES			
Percentage Depletion	Repealed	Repealed	Yes
Expensing Exploration, Development Costs	Repealed	Repealed	Yes
Intangible Drilling Costs	Repealed	Repealed	Yes
Capital Gains Coal Royalties	Repealed	Repealed	Yes
Alternative Fuel Credit	Repealed	Repealed	Yes
Alcohol Fuel Credit	Repealed	Repealed	Yes
Energy Conservation Credit	Repealed	Repealed	Yes
Capital Gains Timber	Repealed	Repealed	Yes
ITC, Seven Year Amortization Reforestation Expenses	Repealed	Repealed	Yes
Capital Gains Iron Ore	Repealed	Repealed	Yes
Expensing Tertiary Injectants	Repealed	Repealed	Yes
AGRICULTURE			
Expensing Capital Expenditures	Modified	Modified	Yes
HOUSING			
Credit Union Exclusion	Retained	Repealed	Yes
Historic Structure Credit	Repealed	Repealed	Yes
Rehabilitation Credit	Repealed	Repealed	Yes
Five Year Amortization Housing Rehabilitation	Repealed	Repealed	Yes

Rapid Amortization of Low Income Housing	Repealed	Repealed	Yes
	COMMERCE GENERALLY		
Excess Bad Debt Reserves	Repealed	Repealed	Yes
Safe Harbor Leasing	Repealed	Repealed	Yes
R&D Credit	Repealed	Repealed	Yes
	TRANSPORTATION		
Shipping Company Definitions	Repealed	Repealed	Yes
	EDUCATION AND TRAINING		
Targeted Jobs Credits	Repealed	Repealed	Yes
ESOPs	Repealed	Repealed	Yes
Expensing Magazine Circulation Costs	Repealed	Repealed	Yes
	HEALTH		
Five year Amortization of Pollution Control	Retained	Repealed	Yes
	INTERNATIONAL		
Controlled Foreign Corporations	No change	No Deferral	Yes
Domestic International Sales Corporations	Repealed	Repealed	Yes
Maritime Construction Fund Exclusion	Repealed	Repealed	Yes
Possessions Corporation Credit	Retained	Repealed	Yes
	CHARITABLE		
Corporate Charitable Deduction	Retained	Deduct 1/2	Yes
	CORPORATE REORGANIZATIONS		
Stock-Debt Swap Exclusion	Repealed	Repealed	Yes
Liquidation Nonrecognition	Repealed	Repealed	Yes

Source: Tax Notes, June 4, 1984, pp 1095-1100.

Bill Bradley
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ADVANCE RELEASE AT NOON THURSDAY, APRIL 14, 1983

WASHINGTON -- Sen. Bill Bradley, D-N.J., and Rep. Richard Gephardt, D-Mo., today proposed a "Fair Tax Act of 1983" to restructure the federal income tax law for individuals and corporations. Bradley, a member of the Senate Finance Committee, and Gephardt, who serves on the House Ways and Means Committee, outlined their plan in speeches at the National Press Club. Attached are copies of their prepared remarks and background information including specifics of the proposal and examples of how it would affect taxpayers.

Remarks by Senator Bradley:

Once again, the annual ritual of paying income taxes is nearing an end. By midnight tomorrow, it will be over officially.

If the experts are right, the Internal Revenue Service will collect some $300 billion from about 96 million taxpayers. Corporations will pay about another $50 billion.

But our income tax isn't working well anymore. It's unfair. It's overly complex. And it's distorting investment decisions, reducing our capacity as a nation to grow in an increasingly competitive world economy.

We have to restructure our tax system, and the sooner the better.

We need a tax system in which all citizens with equal incomes are treated essentially the same way. We need a tax system simple enough for all citizens to have at least a basic understanding of how it works and how their own tax obligations are determined. We need a tax system which encourages people to make investments to make money -- instead of making investments in which they lose money just to lower their tax liability.

It won't be easy to set a new direction. Much has changed since the federal income tax first took effect in 1913, requiring payments only by the wealthiest 1% of the population and producing a grand sum of $35 million. As the years passed and revenue needs increased, tax rates went up and more and more Americans had to start paying taxes. In time, repeated attempts to use the tax code as a vehicle for political favoritism and social engineering turned it into a crazyquilt of deductions, credits and exclusions. It has reached the point where the tax code now spans more than 2,000 pages! And it is estimated that slightly more than 100 major personal and business "loopholes" will be worth at least $250 billion this year.

With this increased complexity, many taxpayers have been forced to struggle with voluminous instructions and intimidating forms or go reluctantly to tax specialists for assistance. More than half of all tax returns are now filed with professional help. For taxpayers preparing their own returns, there are guidebooks promising legal tips to beat the system and suggesting that only a fool would ignore them.

For example, there is one guide with an introductory page that says: "Uncle Sam is your silent partner and the more silent you can keep him in regard to your income tax return, the better." Or how about the combination book and tape recording advertised under the headline, "Pay Zero Taxes." The ad explains that "to pay zero taxes, you need to know the insider procedures."

So it isn't surprising when public opinion surveys show that a lot of taxpayers are wondering whether other people are cutting corners and paying less than their fair share of the burden. Last year, for instance, a Louis Harris poll found that almost half the people questioned did not believe the tax system is fair. In addition, 86% of them said that they believed most higher income people get out of paying much of their taxes by using loopholes.

When so many people share such feelings, they are bound to lose respect for the integrity of the tax laws. No longer can we boast about voluntary compliance that used to be the envy of the industrial world. Instead, we have more and more under-reporting and genuine evasion. This year, the IRS estimates that about $100 billion in income taxes owed will not be paid.

Finally, the availability of so many special provisions in the tax code narrows the size of the tax base. That means tax rates must be high to raise sufficient revenues. But high tax rates only serve to limit incentives to work more, to save more and to invest more.

Cleaning up the tax code for individuals is not enough, however. The income tax for corporations also is laden with preferences and loopholes that are impeding economic efficiency.

Industries receiving preferential tax treatment attract investment that would be made more profitably elsewhere if the free market were allowed to work its will. This loss grows and compounds itself over time. Further misallocations of resources arise from the much-heralded depreciation system which the Reagan Administration proposed and Congress enacted in 1981. This system imposes widely varying tax burdens on investments in different forms of plant and equipment. It also senselessly favors some assets over others. As a result, investment is diverted from one industry to another, and from one type of asset to another within the same industry. The 1982 tax bill ended the worst of these distortions, but the bulk of the problem is still very much with us.

So while we profess to believe in the free market system, section after section of the tax code tells new investors what lines of business to enter, tells existing corporations how to go about their work, and puts a heavy tax on the profits of successful and productive corporations.

The whole system makes no economic sense.

We need a tax system that rewards attainment of the real goal -- profit -- by taxing it at the lowest possible rate. Under such a system, firms could not increase their after-tax income by collecting tax preferences for some tangential activities. Potential investors could maximize their returns by putting their capital where the market -- not the tax law -- tells them.

For all these reasons, Rep. Dick Gephardt and I are sponsoring "The Fair Tax Act of 1983," which proposes a simple progressive tax. This legislation would revamp the tax law for individuals and for corporations by the best means available: lower the tax rates and broaden the tax base through elimination of most existing tax loopholes.

For individuals, the simple progressive tax would have three rates -- 14%, 26% and 30%. Roughly four out of five taxpayers will pay only the bottom 14% rate. The only people paying the higher rates will be individuals with adjusted gross incomes above $25,000 and couples over the $40,000 mark.

Our bill makes another significant change which is directed primarily at low-income people, but flows through to the rest of the taxpayers as well. Putting it simply, we want to increase the amount of money that a person can earn before having to pay any taxes at all. So we are calling for a larger personal exemption of $1,600 for any taxpayers and spouses plus a bigger standard deduction of $3,000 for single returns and $6,000 for joint returns. Taken together, these provisions would allow a couple with two children to earn up to $11,200 before receiving their first dollar of taxable income.

To make this approach politically possible, we recognize that it is necessary to preserve certain deductions, credits and exclusions generally available for many years to most taxpayers. We thus propose to retain the $1,000 exemptions for dependents, the elderly and the blind. We also want to permit deductions for home mortgage interest, charitable contributions, state and local income and real property taxes, payments to IRA's and Keogh plans, some medical expenses and employee business expenses. Lastly, we favor continued exclusion of veterans benefits, Social Security benefits for low and moderate income persons, and interest on general obligation bonds. These personal exemptions and itemized deductions would apply against the 14% rate.

For corporations, our legislation would establish a single tax rate of 30% and leave the level of corporate income tax revenues virtually unchanged. Our bill would do away with most of the tax preferences that now selectively reduce tax liability and distort investment decisions. The tax subsidies for capital investment would be made more uniform and neutral. The investment tax credit would be repealed and there would be a simple and more rational depreciation system. The new system would equalize the tax burdens on different kinds of assets, putting scarce capital to the most efficient use.

The depreication system in this legislation provides each asset to be placed in one of six classes, according to the length of its expected useful life. Each firm maintains one depreciation account for each of the six life classes. The firm adds the cost of each asset it buys to the depreciation account of the appropriate life class, and each year writes off a fixed percentage of the undepreciated balance in each account. (The rates at which the balances are written off are highest for the shortest-lived assets, and the lowest for the longest-lived assets.) This system is simpler than the current law because the firm need not maintain spearate accounting of the depreciation of each asset it buys; it need only know the remaining undepreciated balance in each of its six accounts.

The rates at which the balances in the accounts are depreciated have been chosen to mirror the rates at which the assets actually wear out--what has come to be called economic depreciation--at a discount rate of 10%. This allows for a modest, uniform subsidy for capital investment at current inflation rates. The overall subsidy is smaller, and its distribution among types of assets is far more neutral, than under current law. In fact, the dispersion of effective tax rates on different types of investment is virtually eliminated--as is, therefore, the resulting distortion of investment.

When ACRS, safe harbor leasing, and their companion corporate tax provisions were being sold to the Congress in 1981, they were billed as the beginning of a new era. They may well have been, but it was not the era that the administration had in mind. The Bradley-Gephardt proposal will not be launched with any such hyperbole. No tax system is itself the sole generator of economic growth. Rather, any tax system is a hurdle that the economy must overcome; the goal of tax policy is to make that hurdle as small as possible. After the Bradley-Gephardt proposal is enacted, the challenge of economic growth will still be where it always is: in the private sector of our economy. The difference will be that the private sector will not have to fight the tax system in order to grow.

A few final points must be made. Because this legislation smoothes out the tax rate schedule for individuals, it sharply reduces the major current problems of "bracket creep" and the "marriage penalty."

Throughout this bill, the changes are designed to take effect in 1985 and to raise approximately the same revenues now expected that year under existing law. And all of this would be done without changing the tax burden for any income group. Transition questions will require that some tax preferences be phased out gradually rather than changed abruptly. However, to establish lower rates and fewer loopholes as a direction for tax policy, 1985 serves as the baseline for our analysis.

We also want to stress that this is a simple progressive tax system. It is not a flat tax system, which would shift the tax burden from upper income to middle and lower income Americans. We have taken the progressive route because we believe that someone who has benefitted substantially from our economic system should give back a little more than people who are struggling from paycheck to paycheck. That is a longstanding policy for income taxes in America, and continued public support for it is very evident in every opinion survey that we have seen.

Within each income group, there will be winners and losers. The biggest winners will be people who now take little or no advantage of tax breaks in the current law. Citizens claiming relatively few itemized deductions either will be better off under the new system, or, at worst, see their tax burden remain about the same. Those taxpayers who make the greatest use of existing preferences will experience the most significant increase in tax liabilities under the proposed system.

Approximately 70% of the taxpayers will be paying less tax with this simple progressive tax.

In conclusion, I want to make clear that we are well aware that recent years have seen Congress and Administration officials call attention to the need for tax simplification and then compound the problems. We have already heard many people say that our plan cannot succeed because all the special interest groups now enjoying benefits under the tax code will fight to save them.

But we believe that the nation cannot prosper as it should if the current tax system is not overhauled, and that members of Congress have comt to understand that Americans at all income levels are fed up with the present system. If so, this may be a real opportunity to move in a new direction -- on grounds that the general interest is best served by dropping tax rates dramatically, simplifying the tax system so that all can understand it, and making it fairer.

Remarks of Congressman Richard A. Gephardt on the Fair Tax Plan
National Press Club, Washington, D.C. April 14, 1983

I would just like to make some comments about why we are doing this now. In the past few months, as we've worked to come up with the specifics of our plan, people have constantly asked why we were concentrating on this type of procedural or structural reform when our nation faced so many obvious, and seemingly more immediate, problems. My answer is simply that the current system defies defense and has become an impediment to solving other problems.

It is beginning to crumble under its own weight. When people ask us to address their problems by simply grafting on yet another new tax preference, they fail to recognize that they're actually worsening our general situation. Our efforts to create a level playing field for business in recent years are a case in point. First we tried to smooth out disparities among various profitable businesses. Then we went a step further by giving tax benefits to businesses that weren't profitable. It is an endless process. With this plan, we reverse course and simply begin with a flat field, instead of adding still more cumbersome mechanical devices to jack up sections of the field that are already hovering well off the ground.

Whenever I try to come up with a logical explanation of our current tax system, I find myself turning, not surprisingly, to a journalist, George Orwell, and his analysis of a system where all were equal, but some were a bit more equal than others. So it is with our tax system. All are equal in that we use the same forms and obey the same laws. But some are more equal because they have expert tax counsel, or capital gains, or new storm windows. I remember when I was a kid I used to marvel at reports about American automobile factories that could turn out more than a million different cars without duplication. Sometimes now I think we could line up a million Americans making the same wage and come out with a million unduplicated tax bills. That's impressive flexibility in an auto production line, but it is insanity in a tax system.

When I make this argument, I'm not just saying that I'm intellectually offended by the messiness of our system. I think the problem is deeper and more serious than that because our tax system says something very basic about where American society is headed. Many critics today say we've lost sight of the public interest as we all pursue our separate special interests. Some may say that the public interest is little more than the sum of all our special interests, but I think they are wrong.

Today's tax code is nothing more than a codification of special interests. We don't have a single code. Instead we have one for the banking industry and another for big oil. There's one set of rules for those who weatherstrip their windows and another for those who install solar heaters. And if solar heat deserves a boost, then surely gasohol and geothermal energy cannot be ignored.

I believe that the loss of faith in the tax system and the loss of confidence in our political system are linked and that you cannot restore one without the other. People think that our government reflects the special interests and that our tax system does likewise. It is hard to argue with them.

I've come to this depressing conclusion during the course of my work with many groups trying to revitalize the American economy. Our tax plan is an important part of that package for two reasons. First, there is the obvious technical reason that it encourages investors to make rational economic decisions rather than distorting them to game the tax code. That's a step forward.

But more important is the signal we are sending. This is a single tax system for all the people. If your neighbor earns about the same amount as you do, he'll pay approximately the same tax bill. You'll no longer have to worry about whether he's plugged into the latest tax avoidance scheme. A business earning millions in profits will pay about the same tax whether it makes crates, computers or cartoons.

This system will create public trust where virtually none now exists. And this trust will make it easier for us to solve other problems.

I preach greater cooperation among government, labor and business, but find that each group is wary of the others. To many the idea of doing something for the common good sounds either silly or sappy. That attitude, more than the OPEC control of oil prices, is what's crippling our economy. If we cannot reverse it, we canot progress. I think the tax system is a logical place to begin this process.

This orientation explains why we've structured the play the way we have and why we have purposely sidestepped several questions because of our interest in uniting rather than dividing. Our plan does nothing to change the tax obligations of various income groups. We don't say that the rich should pay more or that the poor should pay more. Similarly, the proportion of the tax burden that business is asked to pay remains constant. We don't disturb the existing relationship between business and personal taxes. We have tried instead to carefully define the issue to contain debate and forge a common position.

If we don't make things better, they will get worse. We can't retain the status quo, as imperfect as it is. If we don't move toward simplification, we will instead slip increasingly under the control of our special interest constituencies. If we continue to try to level the playing field by adding preferences rather than simply bulldozing the entire thing, we may be creating a situation where we will all be poor together.

I think there are several features of our plan that help achieve our goal--the creation of a shared public interest.

First, more than 80 percent of individual taxpayers will pay the same 14 percent tax rate. Virtually everyone will be in the same boat. At the same time, we've structured the Fair Tax so that deductions are worth the same to all taxpayers irrespective of their income levels. The government subsidy to those who are buying a house or supporting a charity will simply be 14 cents on the dollar. Under the current system the government subsidizes fully half the interest costs when a rich person buys a house, but only 12 percent when a poor person does. That's not good tax policy or good housing policy.

By taxing fringe benefits like employer-paid life or health insurance, we eliminate a distorted situation where fringe benefits are worth more than cash compensation.

Incidentally, since we are all now supply siders, I think it is worth mentioning that our plan also contains a very substantial work incentive. When you get a raise, the federal government will never take more than 30 percent of it, compared with a 50 percent top now. That's a 40 percent cut in the top marginal tax rate. Moreover, at every income level, our marginal tax rate is lower than the current rate.

We Democrats on the tax-writing committees have always been somewhat uncomfortable with special capital gains tax rates. On the one hand, we are not insensitive to working class questions about why money made by money is taxed at a lower rate than money earned by labor. On the other, we're sympathetic to the need for savings and investment. We don't think profit is a dirty word. It can be a strong motivation.

Here we've come up with a simple answer -- low rates. A 30 percent top rate is low enough to encourage investment because it is just about where the capital gains tax was until recently. We've eliminated the false distinction between long and short term capital gains and we've responded to the complaints from those who receive all their income as wages. Elimination of the capital gains tax rate is a major step toward simplification.

But if what we've done on the individual side is logical, our plan on the corporate side is positively elegant. We start with a flat 30 percent tax. But the big change comes when we deal with depreciation. No issue in the corporate area has required more attention and added more complexity than capital recovery. Those of you who recall the extensive debate about the treatment of unitary hog-raising structures or how to depreciate a race horse will second my statement. Depreciation is a simple idea -- that if you buy an asset with a limited life, you should be able to retain enough money to buy another one before it wears out and has to be junked.

The execution of this idea has proven incredibly difficult. First, we simply removed mining, forestry and oil drilling from the system and gave each their own set of rules.

Then we decided we should encourage more investment in industry so we sweetened the deal with an investment tax credit that allows investors to recover more than their cost as a subsidy to promote modernization. We decided that historic buildings should be preserved, so we gave developers a special benefit. Then we decided to simplify things by saying that everything had a life of either ten, five or three years. But making that change was too expensive for us, so we phased in the 10-5-3 scheme over a period of years.

This system is complex and distorted. It is also increasingly impossible to administer in a society where math competence is steadily dropping.

So we decided to go back to basics and simply let investors recover their costs-- nothing more and nothing less. We put all assets into one of six pools, depending on how long we anticipate their lasting. We've erased many of the distinctions between manufacturing and mining or drilling. The investor is then simply allowed to deduct a portion of the value in each class annually.

I realize that's probably still a bit complex to fully explain in a speech devoid of diagrams. But take my word for it -- it is quite a bit simpler than the current system that defies description even with sophisticated visual aids.

Finally, I'd like to anticipate one of your questions by predicting in a general way what the future holds for this proposal.

In a nutshell, I'd say that it is going to move and it is going to change. It is going to change because it is both political and imperfect. It isn't a purists' flat-rate scheme, but instead reflects our political judgement about what compromises must be made to create a viable plan. Inevitably our decisions in these areas will be challenged and some of these challenges will succeed. We can justify and defend all of our choices, but there's no immutable rule about which deductions shall live and which die.

The Fair Tax plan is going to move because it is already Democratic dogma. The Democratic midterm convention in Philadelphia last summer endorsed a series of principles for tax reform. Ours is the only plan on the table that is consistent with these tenets. The Democratic State of the Union message in January included our specific plan as part of the Democratic economic recovery program. It is a good bet that this plan will become a plank in the 1984 Democratic platform.

The Republicans interested in tax reform tend toward more doctrinaire solutions. Some have a philosophical problem with progressivity. But many are moving in the same general direction as we are. As I said earlier, we're trying to do something in the national interest instead of continuing to cater to the special interests. Many of my Republican colleagues share this sentiment and believe that government action is needed to bring us together to a point where we can begin working together on other problems.

So as those of you in the audience fret about whether your 1982 tax form is correctly filled out and the procrastinators among you wonder whether you're missing a valuable loophole in your haste to meet the April 15 deadline, take heart. Help is on the way. We won't every be able to make paying taxes fun, but we can make it fair. We don't promise you anything more. And I doubt that the American people will settle for anything less.

Congress of the United States
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

MAY 1 1984

Honorable Bill Bradley
United States Senate
Washington, D.C. 20510

Dear Senator Bradley:

As requested, we have computed the tax liability for 1985 under present law, and under the Bradley-Gephardt Fair Tax proposal, for the hypothetical tax returns described in your letter dated April 24, 1984. For each tax return, both the Federal income tax and FICA tax liability are shown.

Also attached are projected 1985 present-law rate schedules for single and joint filers. These schedules were used in the calculations and reflect an estimated indexing adjustment of 4.36 percent.

Our preliminary estimates are still that the Fair Tax Act of 1983 would not have a significant impact on aggregate revenues in 1985 and would not significantly redistribute the tax burden either among income classes or between individuals and corporations.

Enclosures

Sincerely,

David H. Brockway

Case 1: Low-income, Two-earner Married Couple with Two Dependents

		1985 Present Law	Fair Tax	Tax Change
Income	wages, salaries, etc.	15,000	15,000	
	employer-provided life and health insurance	1/	1,350	
	dividends and interest5/	--	--	
	less dividend exclusion	--	1/	
Adjustments	two-earner deduction	500	1/	
Adjusted Gross Income (AGI)		14,500	16,350	
Exemptions	exemption amount3/	4,174	5,200	
Deductions				
	standard deduction	1/	6,000	
Taxable Income		10,326	5,150	
Tax3/		839	721	-118
Credits	child-care	--	1/	
Surtax Taxable Income	AGI	1/	16,350	
	less net interest	1/	--	
	taxable income	1/	16,350	
Surtax		1/	--	--
Income Tax After Credits and Additional Taxes		839	721	-118

		Present Law		Fair Tax		Tax Change
		Spouse 1	Spouse 2	Spouse 1	Spouse 2	
FICA Taxable Income	wages, salaries, etc.	10,000	5,000	10,000	5,000	
	employer-provided life & health insurance	1/	1/	900	450	
	taxable maximum	39,300	39,300	39,300	39,300	
	taxable income	10,000	5,000	10,900	5,450	
FICA Tax4/		1,058		1,153		95
Combined Income and FICA Tax		1,897		1,874		-23

See footnotes at end of tables.

Case 2: Middle-income, Two-earner Married Couple
with Two Dependents

		1985 Present Law	Fair Tax	Tax Change
Income	wages, salaries, etc.	30,000	30,000	
	employer-provided life and health insurance	1/	1,500	
	dividends and interest5/	--	--	
	less dividend exclusion	--	1/	
Adjustments	two-earner deduction	1,000	1/	
Adjusted Gross Income (AGI)		29,000	31,500	
Exemptions	exemption amount3/	4,174	5,200	
Deductions				
	child care	1/	2,000	
	standard deduction	1/	6,000	
Taxable Income		24,826	18,300	
Tax3/		3,430	2,562	-868
Credits	child-care	400	1/	
Surtax Taxable Income	AGI	1/	31,500	
	less net interest	1/	--	
	taxable income	1/	31,500	
Surtax		1/	--	--
Income Tax After Credits and Additional Taxes		3,030	2,562	-468

		Present Law Spouse 1	Present Law Spouse 2	Fair Tax Spouse 1	Fair Tax Spouse 2	Tax Change
FICA Taxable Income	wages, salaries, etc.	20,000	10,000	20,000	10,000	
	employer-provided life & health insurance	1/	1/	1,000	500	
	taxable maximum	39,300	39,300	39,300	39,300	
	taxable income	20,000	10,000	21,000	10,500	
FICA Tax4/		2,115		2,221		106
Combined Income and FICA Tax		5,145		4,783		-362

Case 4: High-income, Two-earner Married Couple with Two Dependents

		1985 Present Law	Fair Tax	Tax Change
Income	wages, salaries, etc.	60,000	60,000	
	employer-provided life and health insurance	1/	1,800	
	dividends and interest5/	200	200	
	less dividend exclusion	-200	1/	
Adjustments	two-earner deduction	2,000	1/	
Adjusted Gross Income (AGI)		58,000	62,000	
Exemptions	exemption amount3/	4,174	5,200	
Deductions				
	child care	1/	3,000	
	charitable	1,500	1,500	
	mortgage interest	4,800	4,800	
	non-mortgage interest2/	--	--	
	property & income taxes	4,400	4,400	
	other taxes	800	1/	
	less ZBA floor3/	-3,548	1/	
Taxable Income		45,874	43,100	
Tax3/		9,563	6,034	-3,529
Credits	child-care	600	1/	
Surtax Taxable Income	AGI	1/	62,000	
	less net interest	1/	-200	
	taxable income	1/	61,800	
Surtax		1/	2,616	2,616
Income Tax After Credits and Additional Taxes		8,963	8,650	-313

		Spouse 1	Spouse 2	Spouse 1	Spouse 2	
FICA Taxable Income	wages, salaries, etc.	40,000	20,000	40,000	20,000	
	employer-provided life & health insurance	1/	1/	1,200	600	
	taxable maximum	39,300	39,300	39,300	39,300	
	taxable income	39,300	20,000	39,300	20,600	
FICA Tax4/		4,181		4,223		42
Combined Income and FICA Tax		13,144		12,873		-271

See footnotes at end of tables.

Case 6: High-income, Two-earner Married Couple with Two Dependents and Substantial Unearned Income

		1985 Present Law	Fair Tax	Tax Change
~~Income~~	wages, salaries, etc.	60,000	60,000	
	employer-provided life and health insurance	1/	1,800	
	dividends and interest5/	60,000	60,000	
	less dividend exclusion	-200	1/	
Adjustments	two-earner deduction	2,000	1/	
Adjusted Gross Income (AGI)		117,800	121,800	
Exemptions	exemption amount3/	4,174	5,200	
Deductions				
	child care	1/	4,000	
	charitable	5,000	5,000	
	mortgage interest	5,000	5,000	
	non-mortgage interest2/	5,000	5,000	
	property & income taxes	10,000	10,000	
	other taxes	1,200	1/	
	less ZBA floor3/	-3,548	1/	
Taxable Income		90,974	87,600	
Tax3/		27,789	12,264	-15,525
Credits	child-care	800	1/	
Surtax Taxable Income	AGI	1/	121,800	
	less net interest	1/	10,000	
	taxable income	1/	111,800	
Surtax		1/	10,488	10,488
Income Tax After Credits and Additional Taxes		26,989	22,752	-4,237

		Spouse			
		1	2	1	2
FICA Taxable Income	wages, salaries, etc.	40,000	20,000	40,000	20,000
	employer-provided life & health insurance	1/	1/	1,200	600
	taxable maximum	39,300	39,300	39,300	39,300
	taxable income	39,300	20,000	39,300	20,600

	1985 Present Law	Fair Tax	Tax Change
FICA Tax4/	4,181	4,223	42
Combined Income and FICA Tax	31,170	26,975	-4,195

See footnotes at end of tables.

Case 9: High-income, Two-earner Married Couple with Two Dependents and Oil-Drilling Partnership Income

		1985 Present Law	Fair Tax	Tax Change
Income	wages, salaries, etc.	200,000	200,000	
	employer-provided life and health insurance	1/	3,200	
	dividends and interest 5/	800,000	800,000	
	less dividend exclusion	-200	1/	
	Oil & Gas Partnership revenues	100,000	100,000	
	less intangible drilling costs (IDC's)	-1,000,000	-125,000	
	less percentage depletion	-65,000	--	
Adjustments	two-earner deduction	3,000	1/	
Adjusted Gross Income (AGI)		31,800	978,200	
Exemptions	exemption amount 3/	4,174	5,200	
Deductions				
	child care	1/	4,800	
	charitable	50,000	50,000	
	mortgage interest	10,000	10,000	
	non-mortgage interest 2/	100,000	100,000	
	property & income taxes	110,000	110,000	
	other taxes	4,000	1/	
	less ZBA floor 3/	-3,548	1/	
Taxable Income		0	698,200	
Tax 3/		0	97,748	97,748
Credits	child-care	800	1/	

Case continued on next page

See footnotes at end of tables.

Case 9: High-income, Two-earner Married Couple with Two Dependents and Oil-Drilling Partnership Income (cont.)

		1985 Present Law	Fair Tax	Tax Change
Minimum or Surtax Taxable Income	AGI	31,800	978,200	
	plus IDC preference	800,000	1/	
	plus percentage depletion preference	65,000	1/	
	plus excluded dividends	200	1/	
	less charitable deduction	-50,000	1/	
	less home mortgage deduction	-10,000	6/	
	less net interest deduction	-100,000	-110,000	
	taxable income	737,000	868,200	
Minimum Tax or Surtax		139,400	131,512	-7,888
Income Tax After Credits And Additional Taxes		139,400	229,260	89,860

		Spouse 1	Spouse 2	Spouse 1	Spouse 2
FICA Taxable Income	wages, salaries, etc.	75,000	75,000	75,000	75,000
	employer-provided life & health insurance	1/	1/	1,600	1,600
	taxable maximum	39,300	39,300	39,300	39,300
	taxable income	39,300	39,300	39,300	39,300

	1985 Present Law	Fair Tax	Tax Change
FICA Tax4/	5,541	5,541	--
Combined Income and FICA Tax	144,941	234,801	89,860

See footnotes at end of tables.

Case a: Low-income, One-earner Married Couple with Two Dependents

		1985 Present Law	Fair Tax	Tax Change
Income	wages, salaries, etc.	10,000	10,000	
	employer-provided life and health insurance	1/	1,300	
	dividends and interest5/	--	--	
	less dividend exclusion	--	1/	
Adjustments	two-earner deduction	--	1/	
Adjusted Gross Income (AGI)		10,000	11,300	
Exemptions	exemption amount3/	4,174	5,200	
Deductions				
	standard deduction	1/	6,000	
Taxable Income		5,826	100	
Tax3/		251	14	-237
Credits	child-care	--	1/	
Surtax Taxable Income	AGI	1/	11,300	
	less net interest	1/	--	
	taxable income	1/	11,300	
Surtax		1/	--	--
Income Tax After Credits and Additional Taxes		251	14	-237

		Present Law Spouse 1	Present Law Spouse 2	Fair Tax Spouse 1	Fair Tax Spouse 2	Tax Change
FICA Taxable Income	wages, salaries, etc.	10,000	--	10,000	--	
	employer-provided life & health insurance	1/	1/	1,300	--	
	taxable maximum	39,300	39,300	39,300	39,300	
	taxable income	10,000	--	11,300	--	
FICA Tax4/		705		797		92
Combined Income and FICA Tax		956		811		-145

See footnotes at end of tables.

Case b: Middle income, One-earner Married Couple with Two Dependents

		1985 Present Law	Fair Tax	Tax Change
Income	wages, salaries, etc.	20,000	20,000	
	employer-provided life and health insurance	1/	1,400	
	dividends and interest5/	--	--	
	less dividend exclusion	--	1/	
Adjustments	two-earner deduction	--	1/	
Adjusted Gross Income (AGI)		20,000	21,400	
Exemptions	exemption amount3/	4,174	5,200	
Deductions				
	standard deduction	1/	6,000	
Taxable Income		15,826	10,200	
Tax3/		1,677	1,428	-249
Credits	child-care	--	1/	
Surtax Taxable Income	AGI	1/	21,400	
	less net interest	1/	--	
	taxable income	1/	21,400	
Surtax		1/	--	--
Income Tax After Credits and Additional Taxes		1,677	1,428	-249

		Spouse 1	Spouse 2	Spouse 1	Spouse 2	
FICA Taxable Income	wages, salaries, etc.	20,000	--	20,000	--	
	employer-provided life & health insurance	1/	1/	1,400	--	
	taxable maximum	39,300	39,300	39,300	39,300	
	taxable income	20,000	--	21,400	--	
FICA Tax4/		1,410		1,509		99
Combined Income and FICA Tax		3,087		2,937		-150

Case c: Middle-income, Two-earner Married Couple
with Two Dependents

		1985 Present Law	Fair Tax	Tax Change
Income	wages, salaries, etc.	40,000	40,000	
	employer-provided life and health insurance	1/	1,600	
	dividends and interest5/	--	--	
	less dividend exclusion	--	1/	
Adjustments	two-earner deduction	1,500	1/	
Adjusted Gross Income (AGI)		38,500	41,600	
Exemptions	exemption amount3/	4,174	5,200	
Deductions				
	child care	1/	2,300	
	charitable	700	700	
	mortgage interest	3,600	3,600	
	non-mortgage interest2/	--	--	
	property & income taxes	2,700	2,700	
	other taxes	500	1/	
	less ZBA floor3/	-3,548	1/	
Taxable Income		30,374	27,100	
Tax3/		4,791	3,794	-997
Credits	child-care	460	1/	
Surtax Taxable Income	AGI	1/	41,600	
	less net interest	1/	--	
	taxable income	1/	41,600	
Surtax		1/	192	192
Income Tax After Credits and Additional Taxes		4,331	3,986	-345

		Spouse 1	Spouse 2	Spouse 1	Spouse 2	
FICA Taxable Income	wages, salaries, etc.	25,000	15,000	25,000	15,000	
	employer-provided life & health insurance	1/	1/	1,000	600	
	taxable maximum	39,300	39,300	39,300	39,300	
	taxable income	25,000	15,000	26,000	15,600	
FICA Tax4/		2,820		2,933		113
Combined Income and FICA Tax		7,151		6,919		-232

See footnotes at end of tables.

Case d: High-income, Two-earner Married Couple

		1985 Present Law	Fair Tax	Tax Change
Income	wages, salaries, etc.	50,000	50,000	
	employer-provided life and health insurance	[1]	1,700	
	dividends and interest[5]	--	--	
	less dividend exclusion	--	[1]	
Adjustments	two-earner deduction	2,000	[1]	
Adjusted Gross Income (AGI)		48,000	51,700	
Exemptions	exemption amount[3]	4,174	5,200	
Deductions				
	child care	[1]	2,600	
	charitable	1,000	1,000	
	mortgage interest	4,200	4,200	
	non-mortgage interest[2]	--	--	
	property & income taxes	3,400	3,400	
	other taxes	500	[1]	
	less ZBA floor[3]	-3,548	[1]	
Taxable Income		38,274	35,300	
Tax[3]		7,055	4,942	-2,113
Credits	child-care	520	[1]	
Surtax Taxable Income	AGI	[1]	51,700	
	less net interest	[1]	--	
	taxable income	[1]	51,700	
Surtax		[1]	1,404	1,404
Income Tax After Credits and Additional Taxes		6,535	6,346	-189

		Present Law Spouse 1	Present Law Spouse 2	Fair Tax Spouse 1	Fair Tax Spouse 2	Tax Change
FICA Taxable Income	wages, salaries, etc.	30,000	20,000	30,000	20,000	
	employer-provided life & health insurance	[1]	[1]	1,020	680	
	taxable maximum	39,300	39,300	39,300	39,300	
	taxable income	30,000	20,000	31,020	20,680	
FICA Tax[4]		3,525		3,645		120
Combined Income and FICA Tax		10,060		9,991		-69

See footnotes at end of tables.

footnotes:

1/ Item does not apply.
2/ The FAIR tax proposal limits nonmortgage interest deductibility to not exceed investment income.
3/ Present-law exemption amount, zero-bracket amount, and positive brackets include a projected indexing adjustment of 4.36 percent.
4/ The FICA tax shown includes only the employee's share; a generally equivalent FICA tax is paid by the employer.
5/ It is assumed that the net interest exclusion will be repealed.
6/ For the surtax, home mortgage interest is included in the net interest deduction.

Representative LONG. Thank you very much, Senator Bradley. We appreciate you coming and I know how much work you and Congressman Gephardt have put into this over the years and I want to encourage you. Congressman Gephardt.

STATEMENT OF HON. RICHARD A. GEPHARDT, A U.S. REPRESENTATIVE IN CONGRESS FROM THE THIRD CONGRESSIONAL DISTRICT OF THE STATE OF MISSOURI

Representative GEPHARDT. Mr. Chairman, thank you very much for allowing us to be here today and allowing us to comment on our tax bill. Senator Bradley has done his usual excellent job of outlining the bill and why we support it. I would like to reflect in my testimony what I believe to be the economic implications of this kind of a change.

I would start by saying that your focus today, I think, is both unusual and appropriate and I commend you for having these hearings on the economic aspects as well as the tax policy ramifications of substantial tax reform.

Since Senator Bradley and I introduced this bill about a year ago, I have come to realize that there are two major and basic reasons for doing major surgery on our Tax Code. The first is, as he has said, the public frustration that is felt about our tax laws. People sense that the law that we are living with today is unfair. And I think the worst part of it is that the American people feel their neighbors and their relatives and their friends are cheating at their expense. They're often right. I would point out one fact. The opponents of our bill often say that we don't need tax reform because 70 percent of the American people are on the short form already, so why in the world do we need to worry about tax reform?

They leave out one other important fact, and that is that about half of that 70 percent still go to H&R Block or some tax preparer to figure out their short form return.

What does this tell you? I believe that tells you that the American people believe that they are missing some deductions, some loophole that their friends and neighbors are getting to the point that they are willing to go down to the local tax preparer to have that short form filled out because of that morbid fear that they are missing something that someone else is enjoying.

I think they resent having to spend extra hard-earned dollars to hire a tax expert to guide them through what they think is the maze of our tax laws, and I think, as Senator Bradley said, we pay a heavy price for their mistrust.

It creates compliance problems that we are all aware of. People increasingly believe that it's permissible, in fact necessary, to cheat to some extent and that everybody else is doing it and getting away with it.

Not only does it make it more difficult for the Government to raise the revenues required, but it makes it also harder for the Government to accomplish anything in any area. And it's my belief that suspicions about the Tax Code translate into a general distrust and distaste for Government.

So today's Tax Code is corroding public trust. Couple that with an administration that constantly reinforces such doubts and doubletalks about taxation by calling tax hikes either a tax reform or revenue enhancement, and you have the ingredients for a situation that is both volatile and depressing.

I think these political reasons are adequate cause for thinking seriously about reforming the tax law. But today, given this subcommittee's charge and emphasis, I would like to focus on a reason that I think is much more important, although less understood by all of us, for this tax reform effort.

I don't mean that in the conventional sense where people complain that every dollar collected in taxes is a dollar drained from the private sector and denied to productive investment. In fact, the case for productive investment becomes more obvious with each passing day. Rather, my complaint is that we are using the Tax Code to direct our economy and that our attempt is a dismal failure.

Worst than that, I argue to you that trying to do that is counterproductive. Our tax laws, however well intentioned, are not yielding economic solutions. Instead, they are causing new economic problems.

With the continuing debate about the 1981 tax bill, there is still doubt about whether we can encourage people to save, but it's clear that we can channel investment into certain areas. Whether we do so wisely is open to question. And I am not just talking about high finance and leveraged buy-outs. One look around the barnyard gives you a good picture of what our tax laws can create.

One of the questions raised when we were discussing the tax bill now in conference was whether to continue special tax incentives for pork producers. Interestingly, pressure for tightening the law came not only from urban liberals but from rural conservatives who are concerned that the new money the incentive was attracting was becoming a threat to the entire conventional pork industry. That's because the new investors weren't even interested in pork profits. All they wanted were tax writeoffs. So they bid up the price of facilities and equipment, while behaving indifferently about the price they ultimately got for their product.

It can be real difficult to compete with someone whose costs are higher than yours but whose prices are lower. The pork producers problem is not an isolated one. Their fellow farmers who specialize in milk have been similarly hit by the syndication of supercows who make milk as efficiently as the Japanese produce cars. And then there are the vineyard owners in California who find they are competing against investors who have little interest in profits. The result is a great glut and hard times for the traditional producers.

These are all economic fads that are the direct result of our current tax law. A few years ago we had a situation where every airline pilot and orthodontist with a few thousand spare dollars was putting them into avocado groves. We have been witnessing a strange situation where the taxwriters in their three-piece suits select a crop of the year.

I don't want to focus here on the harm done to conventional farmers, although there have been some pain in each case I have mentioned. Instead, as one who spends a fair amount of time talking about economic policy and restoring American strength in world markets, I want to raise the question of whether we are putting our investor dollars in the proper places. Are supercows an effective answer to the Japanese challenge? Will the plentitude of pork really respond effectively to Brazilian steel? If not, then why is Government policy encouraging these activities as opposed to other activities?

I would argue that our current tax system is distractingly irrelevant to what is really happening in American society at best, and actually counterproductive at worst.

Even the tax provisions that may move us in a positive direction are much less effective than they could be because of our annual assaults on the code and the never-ending search for new revenue. So there's always a threat that today's deal will be the target of tomorrow's revenue enhancement effort. At minimum, this reinforces the current disturbing emphasis on short-term gain at the expense of longer economic commitments.

The fair tax plan is an attempt at changing the situation and largely splitting the revenue collection system from the economic policy questions. It is an acknowledgement by two members of the tax-writing committees that our efforts to focus and channel investment just do not work.

The fair tax plan for families includes rates of 14, 26, and 30 percent. There is no preferential capital gains rate. Some of the most popular current deductions, including charitable donations and home mortgage interest, are retained, but can only be taken against the 14-percent basic rate. In other words, they are only worth 14 cents on the dollar, which is a limitation over present law on the worth of these deductions.

That changes the current policy of giving the most generous tax subsidies to the richest members of our society. I might mention parenthetically here that we set out to remove as many tax deductions as possible and those that are retained reflect our political judgment about what was required to make the fair tax palatable and feasible.

We are not interested in philosophical purity, but focus instead on putting together a package that can win the necessary votes in the two Houses to become law.

On the corporate side, as Senator Bradley said, the fair tax includes a flat 30-percent tax which is a substantial reduction in the corporate rate, coupled with a revised depreciation plan that links economic life to real life, which is what I think we all believe depreciation is for.

In the area of real estate, for example, we take depreciation period back to 40 years where it was prior to the passage of the 1981 Tax Act, which took it to 15 years, and now we're in the process in this bill that's in conference of going back to 20.

Our aim is to let business take care of business, without regard to tax consequences.

As the Senator said, we collect the same amount of money from the corporate sector as the current law does, but we moderate much of the current disparity between most favored industries and least favored ones.

What we are looking for today is some agreement that radical change is required, that the current tax system, notwithstanding all the investment incentives and other special features it includes, is properly viewed as part of the problem when it comes to creating a healthier economic climate.

In conclusion, let me say that I think the focus and work of this committee on the whole area of tax reform could be most important in the upcoming debate because I believe we must closely examine the economic impact of what we are doing. I do not believe that we can pass tax reform or probably should pass tax reform just on the grounds of tax policy or the ideas of tax fairness alone. If there are compelling economic reasons that we should keep the Tax Code the way it is, then I doubt that we will be able to change the tax law and probably shouldn't.

But if in addition to the code being unfair and too complicated to understand it is creating bad economic outcomes, then I think the case for tax reform is compelling and I believe this committee can be most helpful in reviewing all of these proposals and trying to draw some conclusions about the economic impact of this entire question.

Again, I appreciate the opportunity to be here and I would be happy to engage in any questions.

[The prepared statement of Representative Gephardt follows:]

Prepared Statement of Hon. Richard A. Gephardt

THANK YOU FOR HOLDING THIS HEARING AND ALLOWING ME TO APPEAR BEFORE THE SUBCOMMITTEE TODAY TO REFLECT ON WHAT I BELIEVE THE ECONOMIC IMPLICATIONS OF THE FAIR TAX WILL BE.

I THINK YOUR FOCUS TODAY IS BOTH UNUSUAL AND APPROPRIATE.

SINCE BILL BRADLEY AND I INTRODUCED THIS LEGISLATION ABOUT A YEAR AGO, I'VE COME TO REALIZE THAT THERE ARE TWO BASIC REASONS FOR DOING MAJOR SURGERY ON OUR TAX CODE.

THE FIRST IS PUBLIC FRUSTRATION WITH OUR EXISTING TAX LAWS.

PEOPLE SENSE THAT THE LAW WE ARE NOW LIVING WITH IS UNFAIR.

THEY FEEL THAT THEIR NEIGHBORS ARE CHEATING AT THEIR EXPENSE AND THEY ARE OFTEN RIGHT.

THEY RESENT HAVING TO SPEND EXTRA MONEY TO HIRE A TAX EXPERT TO GUIDE THEM THROUGH THE MAZE OUR TAX LAWS HAVE BECOME.

WE ALL PAY A HEAVY PRICE FOR THEIR DISTRUST.

IT CREATES COMPLIANCE PROBLEMS THAT WE ARE ALL AWARE OF.

PEOPLE INCREASINGLY BELIEVE THAT IT IS PERMISSIBLE TO CHEAT SINCE THEY THINK THAT EVERYONE ELSE IS ALREADY DOING IT -- AND GETTING AWAY WITH IT.

NOT ONLY DOES THIS MAKE IT MORE DIFFICULT FOR THE GOVERNMENT TO RAISE THE REVENUES REQUIRED, BUT IT ALSO MAKES IT HARDER FOR THE GOVERNMENT TO ACCOMPLISH ANYTHING IN ANY AREA.

IT IS MY BELIEF THAT SUSPICIONS ABOUT THE TAX CODE TRANSLATE INTO A GENERAL DISTRUST OF GOVERNMENT.

TODAY'S TAX CODE IS CORRODING PUBLIC TRUST.

COUPLE THAT WITH AN ADMINISTRATION THAT CONSTANTLY REINFORCES SUCH DOUBTS BY TELLING THE PEOPLE THAT THE GOVERNMENT IS THEIR ENEMY AND DOUBLETALKS ABOUT TAXATION BY CALLING TAX HIKES EITHER TAX REFORM OR REVENUE ENHANCEMENT AND YOU HAVE THE INGREDIENTS FOR A SITUATION THAT IS BOTH VOLATILE AND DEPRESSING.

I THINK THESE POLITICAL REASONS ARE ADEQUATE CAUSE FOR THINKING SERIOUSLY ABOUT MAKING SOME BASIC CHANGES IN OUR TAX SYSTEM.

BUT TODAY, GIVEN THIS SUBCOMMITTEE'S EMPHASIS, I'D LIKE TO FOCUS ON A REASON THAT I THINK IS MUCH MORE IMPORTANT, ALTHOUGH MUCH LESS UNDERSTOOD BY THE AMERICAN PEOPLE.

I DON'T MEAN THAT IN THE CONVENTIONAL SENSE WHERE PEOPLE COMPLAIN THAT EVERY DOLLAR COLLECTED IN TAXES IS A DOLLAR DRAINED FROM THE PRIVATE SECTOR AND DENIED TO PRODUCTIVE INVESTMENT.

IN FACT, THE CASE FOR PUBLIC INVESTMENT BECOMES MORE OBVIOUS WITH EACH PASSING DAY.

RATHER MY COMPLAINT IS THAT WE'RE SUING THE TAX CODE TO DIRECT OUR ECONOMY AND THAT OUR ATTEMPT IS A DISMAL FAILURE.

WORSE THAN THAT, IT IS ACTUALLY COUNTERPRODUCTIVE.

OUR TAX LAWS, HOWEVER WELL-INTENTIONED, ARE NOT YIELDING ECONOMIC SOLUTIONS.

INSTEAD THEY'RE CAUSING NEW ECONOMIC PROBLEMS.

WITH THE CONTINUING DEBATE ABOUT THE 1981 TAX BILL, THERE'S STILL SOME DOUBT ABOUT WHETHER WE CAN ENCOURAGE PEOPLE TO SAVE, BUT IT IS CLEAR THAT WE CAN CHANNEL INVESTMENT.

WHETHER WE CAN DO SO WISELY, HOWEVER, IS OPEN TO SERIOUS QUESTION.

I'M NOT JUST TALKING ABOUT HIGH FINANCE AND LEVERAGED BUYOUTS HERE.

ONE LOOK AROUND THE BARNYARD GIVES YOU A GOOD PICTURE OF WHAT OUR TAX LAWS ARE CREATING.

ONE OF THE QUESTIONS RAISED WHEN WE WERE DISCUSSING THE TAX BILL NOW IN CONFERENCE WAS WHETHER TO CONTINUE SPECIAL TAX INCENTIVES FOR PORK PRODUCERS.

INTERESTINGLY, PRESSURE FOR TIGHTENING THE LAW CAME NOT FROM URBAN LIBERALS, BUT FROM RURAL CONSERVATIVES WHO ARE CONCERNED THAT THE NEW MONEY THE INCENTIVE WAS ATTRACTING WAS BECOMING A THREAT TO THE ENTIRE CONVENTIONAL PORK INDUSTRY.

THAT'S BECAUSE THE NEW INVESTORS WEREN'T EVEN INTERESTED IN PORK PROFITS.

ALL THEY WANTED WAS TAX WRITE-OFFS.

SO THEY BID UP THE PRICE OF FACILITIES AND EQUIPMENT WHILE BEHAVING INDIFFERENTLY ABOUT THE PRICE THEY ULTIMATELY GOT FOR THEIR PRODUCT.

IT CAN BE REAL DIFFICULT TO COMPETE WITH SOMEONE WHOSE COSTS ARE HIGHER THAN YOURS, BUT WHOSE PRICES ARE LOWER.

THE PORK PRODUCERS' PROBLEM IS NOT AN ISOLATED ONE.

THEIR FELLOW FARMERS WHO SPECIALIZE IN MILK HAVE BEEN SIMILARLY HIT BY THE SYNDICATION OF SUPERCOWS WHO MAKE MILK AS EFFICIENTLY AS THE JAPANESE PRODUCE CARS.

AND THEN THERE ARE THE VINEYARD OWNERS IN CALIFORNIA WHO FIND THEY ARE COMPETING AGAINST INVESTORS WHO HAVE LITTLE INTEREST IN PROFITS.

THE RESULT IS A GRAPE GLUT AND HARD TIMES FOR THE TRADITIONAL PRODUCERS.

THESE ARE ALL ECONOMIC FADS THAT ARE THE DIRECT RESULT OF CURRENT TAX LAW.

A FEW YEARS AGO WE HAD A SITUATION WHERE EVERY AIRLINE PILOT AND ORTHODONTIST WITH A FEW THOUSAND SPARE DOLLARS WAS PUTTING THEM INTO AVOCADO GROVES.

WE HAVE BEEN WITNESSING A STRANGE SITUATION WHERE THE TAX-WRITERS IN THEIR THREE-PIECE SUITS SELECT A CROP OF THE YEAR.

I DON'T WANT TO FOCUS HERE ON THE HARM DONE BY CONVENTIONAL FARMERS, ALTHOUGH THERE HAS BEEN SOME PAIN IN EACH CASE I'VE MENTIONED.

INSTEAD, AS ONE WHO SPENDS A FAIR AMOUNT OF TIME TALKING ABOUT ECONOMIC POLICY AND RESTORING AMERICAN STRENGTH IN WORLD MARKETS, I WANT TO MERELY RAISE THE QUESTION OF WHETHER WE'RE PUTTING OUR INVESTOR DOLLARS IN THE PROPER PLACES.

ARE SUPERCOWS AN EFFECTIVE ANSWER TO THE JAPANSES CHALLENGE?

WILL A PLENTITUDE OF PORK REALLY RESPOND EFFECTIVELY TO BRAZILIAN STEEL?

IF NOT, THEN WHY IS GOVERNMENT ENCOURAGING THESE ACTIVITIES?

I WOULD ARGUE THAT OUR CURRENT TAX SYSTEM IS DISTRACTINGLY IRRELEVANT TO WHAT IS REALLY HAPPENING IN AMERICAN SOCIETY AT BEST AND ACTUALLY COUNTERPRODUCTIVE AT WORST.

EVEN THE TAX PROVISIONS THAT MAY MOVE US IN A POSITIVE DIRECTION ARE MUCH LESS EFFECTIVE THAN THEY COULD BE BECAUSE OF OUR ANNUAL ASSAULTS ON THE CODE IN THE NEVER-ENDING SEARCH FOR NEW REVENUE.

SO THERE'S ALWAYS A THREAT THAT TODAY'S DEAL WILL BE THE TARGET OF TOMORROW'S REVENUE ENHANCEMENT EFFORT.

AT MINIMUM, THIS REINFORCES THE CURRENT DISTURBING EMPHASIS ON SHORT-TERM GAIN AT THE EXPENSE OF LONGER COMMITMENTS.

THE FAIR TAX PLAN IS AN ATTEMPT AT CHANGING THIS SITUATION AND LARGELY SPLITTING THE REVENUE COLLECTION SYSTEM FROM THE ECONOMIC POLICY QUESTIONS.

IT IS AN ACKNOWLEDGMENT BY TWO MEMBERS OF THE TAX-WRITING COMMITTEES THAT OUR EFFORTS TO FOCUS INVESTMENT JUST HAVEN'T WORKED.

THE FAIR TAX PLAN FOR FAMILIES INCLUDES TAX RATES OF 14%, 26% AND 30%.

THERE'S NO PREFERENTIAL CAPITAL GAINS RATE.

SOME OF THE MOST POPULAR CURRENT DEDUCTIONS, INCLUDING CHARITABLE DONATIONS AND HOME MORTGAGE INTEREST ARE RETAINED, BUT CAN BE TAKEN ONLY AGAINST THE 14% BASIC RATE.

THAT MEANS THAT EACH DOLLAR SPENT ON SUCH ACTIVITY RESULTS IN A 14 CENT TAX REDUCTION REGARDLESS OF ONE'S INCOME.

THAT CHANGES THE CURRENT POLICY OF GIVING THE MOST GENEROUS TAX SUBSIDIES TO THE RICHEST MEMBERS OF OUR SOCIETY.

I MIGHT MENTION PARENTHETICALLY HERE THAT WE SET OUT TO REMOVE AS MANY TAX DEDUCTIONS AS POSSIBLE AND THOSE THAT ARE RETAINED REFLECT OUR POLITICAL JUDGMENT ABOUT WHO WAS REQUIRED TO MAKE THE FAIR TAX PALATABLE.

WE'RE NOT INTERESTED IN PHILOSOPHICAL PURITY, BUT FOCUS INSTEAD ON PUTTING TOGETHER A WINNING PACKAGE.

ON THE CORPORATE SIDE, THE FAIR TAX INCLUDE~~S A~~ FLAT 30% TAX COUPLED WITH A REVISED DEPRECIATION PLAN THAT LINKS ECONOMIC LIFE TO REAL LIFE.

IN THE AREA OF REAL ESTATE, FOR EXAMPLE, WE'D TAKE THE DEPRECIATION PERIOD BACK TO 40 YEARS, WHERE IT WAS PRIOR TO THE PASSAGE OF THE 1981 TAX ACT.

OUR AIM IS TO LET BUSINESS TAKE CARE OF BUSINESS WITHOUT REGARD TO TAX CONSEQUENCES.

WE'D COLLECT THE SAME AMOUNT OF MONEY FROM THE CORPORATE SECTOR AS CURRENT LAW DOES.

BUT WE'D MODERATE MUCH OF THE CURRENT DISPARITY BETWEEN MOST-FAVORED INDUSTRIES AND LEAST-FAVORED ONES.

WHAT WE ARE LOOKING FOR TODAY IS SOME AGREEMENT THAT RADICAL CHANGE IS REQUIRED--THAT THE CURRENT INCOME TAX SYSTEM, NOTWITHSTANDING ALL THE INVESTMENT INCENTIVES AND OTHER SPECIAL FEATURES IT INCLUDES, IS PROPERLY VIEWED AS PART OF THE PROBLEM WHEN IT COMES TO CREATING A HEALTHIER AMERICAN ECONOMY.

Representative LONG. Thank you, Congressman Gephardt, for your excellent statement.

I, too, agree that the economic ramifications of any change in the tax law, particularly in any substantive change, really needs some detailed exploration. I am not sure that that's the primary job of the taxwriting committees. They tend to look at taxes as a source of revenue rather than as a major factor in our long-range economic policy. I think that that's perhaps one of the reasons that our tax system has led us where it has.

I think the ultimate absurdity that I've heard, a lady told me the other day that she was investing $50,000 in salmon farming in California to raise caviar. It's solely a tax deal. Maybe there will be one good result. Maybe the price of caviar is going to go down. That shows you how ridiculous the whole tax system can get. In many instances, it's gotten even more ridiculous than that, but this is one of the recent ones that comes to my mind.

In a minute I'd like to discuss with you two gentlemen the economic ramifications of what changing our tax system would do on our economy in the long range, but I'd first like to discuss with you the practical, political problems involved in getting such a far-sweeping bill as this enacted into law.

I see it being a formidable political task. Of course, I'm impressed by the amount of constituent mail that Senator Bradley has brought here this morning, in excess of 16,000 letters you said, Senator?

Senator BRADLEY. That's correct, Mr. Chairman.

Representative LONG. In excess of 16,000 letters after a minimum publicity campaign, that's impressive.

I do agree with your view that the special interest groups—and there are a lot of them that are going to be affected by this—are going to put up one devil of a fight. Unless we can develop the widespread interest of the rank and file people of the country we are not going to be successful in getting the fair tax enacted into law. I think you are going at it the right way, but it's got to be widely supported in order to be able to get the votes that are required.

If we look back at what's happened with even just the tax cuts and tax increases when we made the incremental changes in the past in the existing Tax Code, they in themselves generate political pressures that are nearly unbearable to all of us. Of course, making more fundamental changes will cause even more pressure. There are going to have to be strong, strong local pressures, including the pressure from the rank and file of the people, in order to adopt the fair tax.

I'd like for both of you to comment on this because I think this goes to the heart of our ability to get it enacted.

Representative GEPHARDT. Well, let me begin by saying that I share your view that this will be exceedingly difficult politically. We have seen in the last 2 or 3 years how difficult it is to do so-called revenue enhancement bills that, in effect, were loophole closers in some ways.

The problem, I think, is most clearly seen in what we tried to do on withholding on dividends and interest where we closed an enforcement loophole, not even an actual loophole in the law, and then had it taken back out by an interest that was expressed through the savings and loans and through the other lobbies and so on.

So I have no illusions about the difficulties of taking all this on. I think there are three necessary ingredients that give me reason to believe this is possible. No. 1, I think you do have to have a President who is committed to tax reform. It may not be the exact plan that is finally arrived at, but you have to have an executive who is committed politically and in every other way to a very high priority, if not a first priority, of substantial tax reform.

Second, I think that the will of the grassroots individuals around the country who want this to happen has to be adequately expressed, as the interest of all the special interests who have been advantaged in the code through the years is obviously going to be expressed.

Third, I believe that this can happen with a helpful push from the need to do budgetary reform and budgetary change, which I sense may happen next year, where we have to make a radical change in the deficit path which requires us to slow down expenditures and raise some revenues. It seems to me that if we are going to raise some revenues—and remember that we've gone from about 23 percent of the GNP coming from taxpayers in 1981 now to about 18.5 percent of GNP. It seems to me if we're going to raise that amount back up to 21 or 22 percent of GNP, you simply cannot lay a surtax on the present system. That would be terribly unfair. It seems to me you have got to do tax reform as you do revenue increases.

So that gives me some reason to believe that politically tax reform could be a part and in the context of budgetary change.

Senator Bradley. I would agree with much of what Congressman Gephardt said. I think that tax reform is a precondition for seriously dealing with the deficit in 1985 and 1986. The pressures that will be generated by the deficit will create a climate in which fundamental reform is more than simply rhetoric but is a real possibility, particularly when the alternatives are put out there.

I mean, look at what they are. A national sales tax, a value added tax, as Dick said, raising the rates or raising taxes on the present unfair structure, a consumption tax of some kind with a whole assortment of problems. I think that the process will inevitably be led in the direction that it has already taken if we do it sequentially, and we will move to a tax system with lower rates and fewer loopholes.

What I meant by "if we do it sequentially" is that if you look at the tax bills of 1981 and 1982, you will see that in 1981 we cut tax rates and in 1982 we closed loopholes, and this year we are also closing loopholes. The problem is we did it sequentially, which means that we had the recession with giant budget deficits that still haunt us. If we were to do it simultaneously, there wouldn't be a dramatic break. There wouldn't be a totally new system with all the problems that would create. I think, therefore, it would be the most familiar to people, when the crunch comes and you clearly need to have the deficit reduced. Revenues are a part of that. The precondition is tax reform, and this changes the way we have traditionally looked at tax reform.

Tax reform used to be viewed, and by some people is still viewed, as an exercise in purification and self-righteousness—we're going to get those people. Well, that's not what the fair tax is. The fair tax is a compact which says, "Look, fairness means equal incomes paying about equal tax," and then deciding how much tax. So the precondition is equal incomes paying equal tax at the lowest possible rate.

I might also add that when you say how are we going to resist the pressures in the political process, and they are clearly there—I am reminded of a story Harry Truman tells—I think it was either in a book by Merle Miller about Harry Truman called "Plain Speaking" or it was in his memoirs—of when he was a Senator and he got 30,000 postcards from his constituents in Missouri urging him to vote against a public utility reform bill. And people said, "What did you do with those?" He said he burned them. They said, "Why did you burn them?" He said, well, he knew how they were ginned up and he had to have some common sense. In the political process I think that's what we're going to need if we're going to move to fundamental tax reform. We are going to need some common sense and an ability to understand who is speaking for whom, and then a real effort, as these bags of mail indicate, to organize the general interest. That is not an easy task, but we are proceeding on a number of levels; and I would say to you, Mr. Chairman, that you would be surprised to know the allies that are emerging who have looked at the fair tax in a nonpolitical way and who recognize its benefits for the economy and for the country.

Representative LONG. It surprised me the amount of mail that I get from local groups on tax simplification.

I think your point with respect to the deficit is well spoken. Maybe it's following that old maxim that things have to get really horrible before we get any action. The bad problem that we have on our national debt and all the inequities in the tax system are inextricably one and the same problem. If we tie them together we might have a chance to overcome this. It's not going to be easy though.

Let me ask you about one of the economic issues involved. A lot of people, particularly those in the administration, felt that when we reduced the base rate and cut the top rate from 70 percent to 50 percent we would encourage people to base business decisions and investment decisions on economic judgments rather than tax gimmicks. Yet, it seems to me—and I haven't looked at the figures on this and you all might know them—it seems to me that we have had as many of the tax loophole businesses around today as we have ever had. and it doesn't seem to me that we've changed it very much by the 1981 tax bill and cutting the high maximum tax rate from 70 to 50 percent.

Is there any reason for us to believe that if we enact something like the fair tax that it would, in fact, encourage businesses to deemphasize tax considerations and focus on economic considerations instead?

Senator BRADLEY. Mr. Chairman, I think that a reform such as the fair tax would clearly break with the tradition that we have seen of proliferating tax shelters. The reason the 1981 act did not accomplish that end is twofold.

First, the rate is still 50 percent as opposed to 30 percent in the fair tax. A 50-percent rate means you're saving 50 cents on each dollar you make if you go into a tax shelter. That would not be the case with the fair tax because the rate would be down to 30 percent.

Second, the 1981 act did not attack the structure of the tax system. It increased the number of loopholes. There were loopholes that were added to the system. We deal with the structure of the system. If you look at tax shelters they are based upon several basic pillars, things like ACRS, ITC, the capital gains rollover, a whole number of them. We address the basic structure of the system, plus we lower the rates much more dramatically. So then I think you would see decisions made on economic grounds, not on tax grounds.

Representative **Long.** I'm inclined to that view, too. Do you have any different view, Congressman Gephardt?

Representative **Gephardt.** I think that adequately covers it. I think the 1981 bill is not a model to look at to see what happens when you do tax reform.

Representative **Long.** It's not a model for fairness either.

Representative **Gephardt.** No. I clearly believe that we added loopholes in that bill of a major kind and encouraged people to be more heavily interested in shelters and in trying to avoid taxes. So I think this is a totally different concept.

Representative **Long.** It was a terrible bill.

Senator, let me ask you a question on the talk that we hear going around on the Kemp-Kasten bill. They call it the FAST tax?

Senator **Bradley.** Yes, I think so.

Representative **Long.** Congressman Kemp and Senator Kasten. How do the two proposals relate?

Senator **Bradley.** Well, Mr. Chairman, let me say that imitation is the sincerest form of flattery. I think it's very important that there has been a bill introduced on the other side that moves in the same direction as we do. I'm pleased it's happened. We have been calling for everybody to get on the same train headed in the direction of lower rates and fewer loopholes. That is the direction that the Kemp-Kasten bill takes and I think that's positive.

However, I think there are also some danger signals in the bill, the main one being it would increase the deficit by a very sizable amount. The committee might want to look at that as well as at some other elements of the bill that would result in much greater benefits going to people with incomes over $100,000.

But I would like to say that it is heading in the same direction as the fair tax and that, in my view, offers an opportunity for some cooperation.

Representative **Long.** I would agree with you. I know you have to go to another hearing and if you would like to go ahead, please feel free to do so. I have one additional question that I'd like to ask Congressman Gephardt. Before you leave Senator Bradley, Congressman Hamilton has just arrived and may have a question for you.

Representative **Hamilton.** Just let me say that we are delighted to have the Senator and Congressman Gephardt with us and I apologize for missing your opening statements.

Representative **Long.** Thank you very much, Senator Bradley.

Senator **Bradley.** Thank you, Mr. Chairman.

Representative **Long.** All of your statements and whatever else you request will be made a part of the record.

Congressman Gephardt, the one central question that comes up in everybody's mind is the home mortgage deduction. Is it fair to people who have been making decisions on the basis of the current tax system for many years to make a major change in tax policy that takes away the deductibility of the 30-year mortgage payments. What would happen under your bill to a family that has a mortgage?

Representative Gephardt. Well, as you know, we retain in our bill the mortgage interest deduction. It is not as valuable a deduction as it is today because we only apply it on that first $40,000 of family income. So it's a 14 cents on the dollar deduction. It is not open-ended the way it is today. For most Americans, that will not be a change in the present situation. They will still get the kind of deduction they have today and will be able to look forward to buying a home and having that deduction present.

It would limit the deduction for very wealthy people who have very big mortgages on very expensive houses and today enjoy an open-ended mortgage.

Representative Long. What would you do about vacation homes and second and third homes and condominiums in Miami and this sort of thing?

Representative Gephardt. My recollection is that we do not close down on present law—I think we keep present law with regard to second homes.

Representative Long. The limitation is the overall limitation on the amount of tax you paid which is, of course, substantially different.

Representative Gephardt. Right. Now let's talk about the present situation. If you're concerned about people who have entered into deals under present law, and then, if we moved to this new law wouldn't they be terribly impacted, I think that's an issue of transition and one that obviously the committees and the Congress would have to address. I personally believe it would be unfair to say to someone, "Gee, you know, you entered into a 30-year deal 5 years ago under the law that existed then, but we're going to change that and take this deduction away from you and put you into bankruptcy or take the home away from you because the law has changed." I don't think you can do that. I can't assure you what kind of a transition rule the Congress would write, but I would assume on the basis of past performance that we would write a generous transition rule that would see most people through their situation and allow them to enjoy present law to the extent that they would need in order to come out.

So I argue to you that we have kept that important deduction for very obvious political and philosophical reasons. We believe that there is a deep feeling among the American people that we need to some extent encourage people to purchase housing and we feel the deduction that we have retained is adequate to that task.

Representative Long. Thank you. Congressman Hamilton.

Representative Hamilton. Thank you very much, Mr. Chairman.

Representative Gephardt. Let me just ask you about the politics of this thing a little bit. I've been in the Congress for a while, and one of the things that strikes me is that when we deal with the income tax we deal with it in an incremental way. In the past several decades, I suppose, we really haven't made radical changes. I know there's an enormous amount of frustration out there in the country with regard to the income tax. But I also know how vigorously changes in the code are fought, because there are a lot of bucks that ride on every—even minor—change.

So, the question is what makes you think that we can push through a really radical change in the income tax code? Is the degree of dissatisfaction and frustration so deep that the people are ready for it? What kind of political leadership will be required to put through this kind of change?

Representative **Gephardt**. Well, I think the theory of tax reform in the past has been kind of the Woody Hayes theory, "4 yards in a cloud of dust, sometimes 3, sometimes you get pushed back." I think that we are about at the end of what we can accomplish in that regard. We have had 2 years of so-called tax reform bills, revenue enhancement bills, by closing the loopholes primarily, some enforcement improvements, but mostly closing of loopholes.

It's been a pretty unhappy exercise, I must tell you. You must remember what we've gone through. As we have closed some loopholes, in later activities we've taken those closures back out. We have lost ground from where we went. And I really believe we're about at the end of the rope. I think we will be years and years and years trying to do this incrementally.

Let me talk for a minute about why that's the case. The underlying assumption of incremental tax reform is that we can go and ask individuals and groups that have been advantaged in the code through the years to give up their advantage in return for nothing than a pat on the back. Most groups, frankly, are not interested in that. They feel it's unfair. They feel they've been singled out and they fight like banshees.

If you can say to groups, "This is not an exercise that just costs you, but as you give up your advantage and as all these groups give up their advantage, we all gain a lower rate," it seems to me from a philosophical viewpoint you at least have a chance of convincing a lot of groups that maybe this is something they can put up with because their bottom line is that they are not going to be so harmed as in an incremental tax reform effort.

Second, I would say to you that you obviously need Presidential leadership. I don't think this is possible unless you have a President who believes in tax reform and will fight in the Congress to get it enacted. We would not have passed the 1982 bill and we would not have passed the 1983 bill unless you had the administration vocally saying to members on both sides of the aisle, "We need and want this bill." I think that's apparent.

Third, as I said previously, I think that the one way you can force through major change, in addition to those first two factors, is if you have major budgetary deficit path change where you have a big reconciliation bill that is asking a lot of different people to sacrifice, in slowdowns, in the domestic and the defense and the foreign budget, in expenditures, and then you ask the taxpayers of the country to increase the amount of GNP that they're willing to pay to help the budgetary situation.

As you know, we were taking in about 23 percent of the GNP before 1981, we're down now to 18.5 percent of the GNP. If you couple major tax reform with revenue increase, which is what I think you have to do in order to get it put together, you can in a reconciliation budgetary context force all of that through, arguing to all the special interests that they will get a lower rate and they do get some advantage from this kind of tax reform.

That's my scenario for politically putting it together. I have no illusion about the difficulty of it, the severity of the political problems, but I believe there is a chance—a 35 percent chance, whatever you want to call it—that this kind of effort has a greater chance in 1985 than it's ever had before.

Representative **Hamilton**. Did I see in the press this morning that the administration now opposes the flat tax? Maybe someone read that article more carefully than I did. Secretary Regan may have been talking about the straight flat tax. Is that your impression as to the administration's position?

Representative **Gephardt**. I cannot tell you what their position is or will be. I'm not sure they know what it is yet.

Representative **Hamilton**. They have not commented on your bill particularly?

Representative **Gephardt**. No. The Treasury is having hearings around the country. They are doing a big study pursuant to the President's State of the Union statement. I believe if I had to predict today that if the administration comes out for tax reform at all, it would be for either more incremental reform with the present system with a VAT or some kind of a consumption or excise tax on top to pick up revenue, or it would be for a consumption income-based tax which would be major tax reform but a very different kind of tax reform than the near flat or the flat tax.

Representative **Hamilton**. I do recall Secretary Regan saying at one point that one of the problems he saw with your tax bill is that it does not sufficiently encourage investment. I think you throw out, do you not, the current capital gains treatment?

Representative **Gephardt**. That's correct.

Representative **Hamilton**. How do you respond to that general criticism?

Representative **Gephardt**. We respond by saying that we believe having a neutral field or a level playing field with regard to investment decisions is the most important economic change that we can make in the Tax Code. I believe that if we put dividends and interest on the same tax level with capital gains, that would be a good thing to do. I also believe that there is no sufficient evidence that if you take the rate for earned and so-called unearned income to a level 30 or 14 or 26 percent, that that will be a radical disincentive to capital investment. I still believe that there will be many, many people who want to invest in ventures, even high risk ventures, that have the high possibility of great return, and that if you put things on a level field that there's no reason to believe that people still will not be willing to go into ventures.

They may have a different attitude about what particular ventures they want to go into, but I don't think it changes their attitude about putting money into capital investments.

There are people who believe that we will hurt the high risk venture market, who say that the differential in the way we tax capital and the way we tax earned income is the important thing. They would argue that it doesn't matter what the differential is, but you've got to have a differential. I don't think that we have the evidence to prove that and obviously, if we went to a flatter or a flat system we could relook at that after a few years experience. But I don't really believe it's going to happen.

Representative HAMILTON. Let me ask you about the basis for your feeling that investment dollars would continue to flow. Is that feeling based on data from other tax systems? Is it based on any kind of empirical studies, or is it just kind of a gut feeling you have that investment dollars would flow?

Representative GEPHARDT. I do not have an empirical study. I would hope that there would be some done. I think that is an important thing to do. However, I quickly add that who does the study and the assumptions that are made are obviously important to the outcome. If you want to show that a flatter tax is going to impede savings and investment, I think it's easy to do that by the way you construct the econometric model and so on.

I believe that there should be studies done, however, but when you come down to it, I think the only way to truly test something is to attempt it. I see no reason that we can't go to a flatter system and give it a couple years and then look at our investment in high risk stocks and our investment in the stock market generally and find its result.

Thus far, we have not heard tremendous outcries from Wall Street or from the stock market community feeling that this would do them in, and that may be the best test of all of what people think is likely to happen.

Representative HAMILTON. Another comment I've heard about the flat tax generally—and your proposal—is that the average guy, whoever that is, would pay more; that the fellow who's on a straight salary who doesn't have a lot of different sources of income, who now pays all of his tax, would pay more; and that the burden of the flat tax really would fall more heavily on low-income and low- and middle-income people than the present system.

I don't have the slightest idea whether that criticism has any validity to it or not, but I would appreciate your observation about it.

Representative GEPHARDT. If you're talking about a totally flat tax, I think that charge is a good one. I think the average- or middle-income taxpayer would suffer under a totally flat tax.

However, we wrote our bill with three brackets, as you know, precisely for the reason that we did not want to take any more money from different income groups. So we did not redistribute the burden of taxation between income groups.

We also believe that under our bill about 70 percent of taxpayers would have either the same tax burden or a lesser tax burden and that most of those people are in all income groups, so obviously our burden falls on people that are heavily leveraged with shelters. But we do not take more from corporations than is now taken. We do not take more from individual income groups. And the more you use shelters, the more tax you would pay under our bill. So there is redistribution within income groups, but not between income groups.

So I would argue to you that the average American under our bill would either pay less taxes or the same amount of taxes, with far less complication and with the faith and the knowledge that everybody in every income group was paying at a much more uniform rate than is the case today.

Representative **Hamilton**. Your effort here is not to raise additional revenues, is it?

Representative **Gephardt**. The bill was not written to raise additional revenues. It does, because we drop out indexing, raise about $25 billion a year more after the third year, but only because of that reason.

Obviously, if you want to combine this kind of tax reform with tax increase, you've got to either raise the three bracket rate schedule that we've come up with or you've got to take out some of the loopholes that we have retained or lessen the amount of those loopholes.

Representative **Hamilton**. We're going to hear tomorrow from congressional sponsors of a bill that is somewhat different from yours, put together by Senator Kasten and Congressman Kemp. One of the things that strikes me is that there are a lot of similarities between the bills. There are some differences—indexing is one—but there are a lot of similarities, too.

Have you made any attempt with them to work out the differences or not?

Representative **Gephardt**. We have not. In response to a similar question previously, Senator Bradley said that the sincerest form of flattery is imitation, and we believe that there's a lot of imitation in the bill and we appreciate that. We have not consulted with them, but clearly the bill is much like our bill. It moves exactly in the same direction. It retains most of the same deductions we do. Its rate structure is different and we believe inferior to ours because we believe it would lower taxes for the higher income groups and increase taxes more than we do for the middle-income groups. It does have a higher exemption level and would exclude more of the low-income taxpayers from the tax system than we do. We go to an $11,000 and below exemption. They get up to $12,000 or $13,000. So they do better on the low end. They do better for the top earners and they do worse for the middle-income people, according to our evaluation.

Representative **Hamilton**. Thank you, Mr. Chairman.

Representative **Long**. Thank you, Congressman Hamilton.

Thank you, Mr. Gephardt. We appreciate you coming.

Representative **Gephardt**. Thank you very much.

Representative **Long**. Our next two witnesses are two outstanding scholars, Mr. Alan J. Auerbach, associate professor of economics, University of Pennsylvania, and Joseph J. Minarik, senior research associate, the Urban Institute.

Gentlemen, we are pleased to have you here. If you have statements you would like to submit for the record they will be made a part of the record and you may proceed in whatever manner you desire. Mr. Minarik, why don't you go first.

STATEMENT OF JOSEPH J. MINARIK, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE

Mr. **Minarik**. Thank you, Mr. Chairman. I appreciate the invitation to speak here. I have a brief statement that I will read and a longer statement that I'd like to have inserted in the record if I could.

Representative **Long**. Without objection.

Mr. **Minarik**. There is a growing consensus that the tax system must be restructured in 1985. Public esteem for the income tax has dropped precipitously, as any number of opinion polls confirm. Further confirmation comes from millions of taxpayers who are voting with their dollars—refusing to pay their tax legally due. From 1973 to 1981, according to the Internal Revenue Service, revenue lost owing to noncompliance more than tripled. Many individual taxpayers believe that the income tax is unfair. Many businessmen believe that it interferes with productivity and business growth. Fewer people believe that they understand the income tax well enough to file their own returns. And all the while, our budget deficit is climbing out of sight.

If we want to pull the deficit down from the stratosphere, we had better get our income taxes—which raise more than half of our total revenues—onto a firm footing. And so we had better unearth the root causes of our income tax problems before 1985. The root of these problems is the attitude that all of us—individual taxpayers, businesses, and tax policymakers and administrators—have come to have toward the tax system.

The market economy in the United States is sometimes called an economic game. Not too long ago, the income tax was separate, just a means of raising revenue. People played the economic game, and then the winners gave a share of their prizes to the Federal Government. But now things are different.

The problem is that the income tax has become a part of the game. The income tax is no longer just a share of the winnings determined by fixed, fair rules. Now it is a measure of success, subject to the control of the taxpayer, like a firm's costs or a household's expenses. With the income tax thrown in, the game has become destructive. There is no longer an agreement on the rules. Some people still play the old way, with taxes a civic duty not to be manipulated. But others jump into the contest head first, using every technique—mostly legal, sometimes illegal—to cut their taxes. Those who still play by the old rules are being eaten alive by others who are not so restrained. And the average taxpayer cannot afford the expert help needed to play the income tax game. Even if he were resigned to his share of the winnings under the old economic game, he is angry because he can't even compete in the tax game. To him, the tax system is unfair because of the advantages others have, and it is too complex because he can't understand how it works.

So everyone loses. The Federal Government loses revenue. Taxpayers lose their trust in the "system"—the income tax system and their Government in general. Perhaps worst of all, everyday people view each other with distrust and suspicion. And while income tax manipulation enriches the clever, it stagnates the society. It is a distortion and a diversion. When people earn income in the traditional market economy, they add to our Nation's wealth. But when people play in the income tax game, they add nothing to our national wealth; they merely transfer wealth from one sector to another. They contribute to their own prosperity, but not to the nation's.

We have to take the income tax out of the economic game. We cannot continue with the income tax as an important strategic and tactical part of our economic life. Inaction will continue to drain the Government's revenues, destroy our national morale, and erode our prosperity.

The Bradley-Gephardt bill would reduce the intrusion of the income tax into our economic life through two steps. First, it would reduce the incentives for tax manipulation by cutting tax rates, and second, it would repeal tax provisions that permit manipulation and distort economic decisions.

This two-point outline is clearly a simplification; it is fleshed out in some detail in the main body of this statement. In summary, Bradley-Gephardt is a simple 14-percent tax for between 75 and 80 percent of all taxpayers—couples with incomes under $40,000, and single people with incomes under $25,000. For these people, for whom tax simplification is most needed, the single rate will help. Above that income level, a graduated surtax raises the tax rate in two steps to 26 and then 30 percent—with the highest rate applying to couples with incomes over $65,000 and single persons with over $37,500. This maximum rate is drastically reduced from the current law's 50 percent. Personal exemptions and standard deductions are substantially increased to remove from the tax rolls all families in officially defined poverty.

These low tax rates are like the reward for capturing an outlaw. One can argue that the reward money will stimulate the frontier economy, but the real social benefit comes from putting the outlaw behind bars. Likewise, we can't cut tax rates without a fiscal disaster unless we close tax loopholes. And even more important, it is the tax loopholes in the current law that put the income tax into the economic game, make the tax system unfair, and distort economic decisions.

Bradley-Gephardt repeals or cuts back a large number of tax preferences. Repealed are several general saving and investment incentives, including the net interest exclusion, the exclusion for long-term capital gains, and the investment tax credit. The accelerated cost recovery system is replaced by a simpler and more economically neutral depreciation system, and maximum contributions to top-heavy pension plans are cut back by one-third. Not changed by Bradley-Gephardt are other pension provisions and IRA and Keogh plans. A number of targeted incentive provisions are repealed, affecting oil and gas, energy conservation, research and development, private-purpose tax-exempt financing, and a host of other activities.

These provisions are repealed because they are inefficient, counterproductive, and unfair. Every selective tax preference allows some tax manipulation, which costs revenues and respect for the tax system. And every incentive rewards some taxpayers for doing what they would have done even without a subsidy. The revenue lost for these reasons forces tax rates up, because we have to collect some minimum amount of revenue to keep the budget under control. And those higher tax rates discourage all economic activity, especially work and all nonsubsidized saving and investment. The result is slower growth of incomes and productivity. By eliminating these tax preferences and keeping tax rates low, Bradley-Gephardt will speed economic growth.

The main focus of the body of my statement is fairness. Bradley-Gephardt will prevent manipulation and tax shelters that allow some people to pay less tax than others with the same income. But Bradley-Gephardt does not redistribute the tax burden among income groups; that is, it does not systematically raise the taxes of one income group and reduce the taxes of another. So every income class, taken as a group, will pay as much as it does now; but within each income class, most taxpayers will pay a bit less, and some will pay more. Those who pay more will be those who make the most use of tax preferences under the current law—in other words, those who now pay less tax than most other people with the same income.

Bradley-Gephardt will raise the same revenues as the current law in its initial year. But it will raise more revenue in later years, because it eliminates tax loopholes that are now growing faster than the economy as a whole. This faster revenue growth can make Bradley-Gephardt the most important part of a program to reduce the Federal budget deficit.

In sum, Bradley-Gephardt will remove the income tax from the economic game. Taxpayers will no longer have to worry that their best efforts as workers or investors are being wiped out by failure to take advantage of some tax gimmick. People with modest incomes won't need to be suspicious that wealthy people are paying less tax than they. And the marketplace, rather than the tax law, will guide our resources and our efforts to their best uses in an increasingly competitive world economy.

[The prepared statement of Mr. Minarik, together with attachments, follows:]

PREPARED STATEMENT OF JOSEPH J. MINARIK

WHY BRADLEY-GEPHARDT?

Testimony of

Joseph J. Minarik
Senior Research Associate
The Urban Institute

I am grateful for the opportunity to testify before this Subcommittee on the Fair Tax Act of 1983, known as the Bradley-Gephardt bill. Let me emphasize that opinions expressed in this statement are my own, and should not be attributed to the Urban Institute, its officers, trustees, or funders.

My mandate from the Subcommittee is to discuss Bradley-Gephardt primarily from the perspective of fairness. Because the bill is called the "Fair Tax," this must be a good place to start. But what sets Bradley-Gephardt apart from all of the other tax restructuring proposals to date is its balance--its ability simultaneously to get closer to all tax policy goals (economic efficiency, simplicity, and a smaller deficit, as well as fairness). Such balance requires a careful tradeoff among these objectives, and so each provision of the bill affects every goal. Thus, even a targeted discussion of fairness in Bradley-Gephardt will necessarily be fairly general.

What Is Wrong With the Income Tax?

There is a growing consensus that the tax system must be restructured in 1985. We must understand the very serious problems that have motivated this consensus before we can solve them.

The symptoms of these problems are rapidly declining public esteem for, and deteriorating compliance with, the tax law. In a 1972 poll, a plurality of the American people (36 percent) identified the federal income tax as the most fair tax in the United States. (This is in comparison to 33 percent who named state sales taxes. Only 19 percent said that the individual income tax was the least fair tax.) But only 11 years later, a poll using identical language and sampling methodology showed that a plurality of the population (35 percent) now believes that the income tax is the least fair tax. A majority of respondents to a more detailed 1978 poll said, above all, that the income tax isn't fair; middle-income persons pay too much, while the wealthy and big corporations pay too little.

A similar message comes from tax-filing behavior. The Internal Revenue Service (IRS) estimates that revenue lost owing to taxpayer noncompliance more than tripled from 1973 to 1981. Indications are that taxpayers are increasingly reluctant to report their own incomes and pay their taxes.

At the same time, businessmen and economists complain that the tax system is stifling enterprise and growth. They blame high tax rates and complex legal provisions that intrude upon private decision-making.

What causes these problems? Popular perceptions of tax unfairness do not arise from any lack of progressivity in the conventional sense. Internal Revenue Service statistics show that tax liabilities as a percentage of income increase smoothly as income increases, so the wealthy do pay a larger share of their incomes in tax on average. Nor is the falling popularity of the income tax caused by more high-income persons avoiding tax entirely; the number of nontaxable upper-income persons has remained small and roughly constant over the past ten years. If we want to find the root of the problems with our tax system, we have to look in a somewhat different direction.

There is a common thread to all of our tax policy problems. It is the attitude that all of us--individual taxpayers, businesses, and tax policymakers and administrators--have come to have towards the tax system.

The market economy in the United States is sometimes called an economic "game." This may seem a fairly casual reference for the economic system in which millions of Americans earn their livelihood; but that is how a market economy works, and that is the way we want it. The game has winners and losers, and it is the winner's prize that motivates people to work hard and come up with the new ideas that make everyone more prosperous.

Not too long ago, the income tax was just a means of raising revenue. People played the economic game, and then the winners gave a share of their prizes to the federal government. But now things are different.

The problem is that the income tax has become a part of the game. The income tax is no longer just a share of the winnings determined by fixed, fair rules. Now it is a measure of success, subject to the control of the taxpayer, like a firm's costs or a household's expenses. Businesses compete with one another to cut their taxes--even by lobbying for favorable targeted tax legislation--just as they fight over customers. And "keeping up with the Joneses" means getting a better tax shelter to help pay for the longer vacation.

With the income tax thrown in, the game has become destructive. There is no longer an agreement on the rules. Some people still play the old way, with taxes a civic duty not to be manipulated. But others jump into the contest head first, using every technique--mostly legal, sometimes illegal--to cut their taxes. Those who still play by the old rules are being eaten alive by others who are not so restrained.

There are still others with a different problem. The average taxpayer, who works for a modest wage or salary to support a family, cannot play the tax game whether he is willing to or not. He cannot afford expert help, and most tax manipulation strategies are only profitable in the higher brackets anyway. Even if the average taxpayer were resigned to his share of the winnings under the old economic game, he is angry because he can't even compete in the tax game. To him, the tax system is unfair because of the advantages others have, and it is too complex because he can't understand how it works.

This limbo between the old and new rules of the game is breaking down our traditional standards. It is hard to resist the appeal of tax reduction strategies, so more and more people decide to play; that is why tax shelter investments have increased so spectacularly. People who are just beginning to climb up the ladder resolve that when they have the wherewithal, they won't be chumps for the tax collector. Each tax advisor--a member of a new profession--has to come up with the raciest deals for his clients; if he doesn't, someone else will. Everybody in the field knows that the IRS does not have the resources to examine even 2 percent of all returns, and so the tax planner can do anything short of the outrageous. And what is "outrageous?" Our standards are changing--some would say deteriorating--every day.

So everyone loses. The federal government loses revenue. Taxpayers lose their trust in the "system"--the income tax system and their government in general. Perhaps worst of all, everyday people view each other with distrust and suspicion. But it doesn't stop there.

The income tax game makes us all poorer. Income tax manipulation enriches the clever but stagnates the society. It is a distortion and a diversion. When people earn income in the traditional market economy, they add to our nation's wealth. In the long run, we all share in this wealth through a larger capital stock and higher wages. When people play in the income tax game, however, they add nothing to our national wealth; they merely transfer wealth from one sector to another. They contribute to their own prosperity, but not to the nation's.

And in the long run, even the selfish products of tax manipulation are illusory. While one taxpayer cuts his tax burden, others are doing the same. Ultimately, the federal government has to collect some given revenue, and so what taxpayers save by manipulating the tax law must be made up by general tax rate increases (or forgone tax rate cuts). It is what has been called "the fool's golden rule;" while one taxpayer is shifting his tax burden to others, those others are shifting it back.

How Can We Fix the Income Tax?

We have to take the income tax out of the economic game. We cannot continue with the income tax as an important strategic and tactical part of our economic life. Inaction will continue to drain the government's revenues, destroy our national morale, and erode our prosperity.

Such substantial reform is easier said than done. There has been growing sentiment for action, but little agreement on what should be done, with serious discussion of such radical steps as new taxes on consumption. For the last two years, however, the Bradley-Gephardt bill has attracted growing attention as a far-reaching but realistic approach. These hearings confirm this interest.

Bradley-Gephardt would reduce the incentives for tax manipulation by cutting tax rates, and would repeal tax provisions that permit manipulation and distort economic decisions. With these two steps, it would reduce the intrusion of the income tax into our economic life.

Reducing Tax Rates

With the onset of supply-side economics, tax rate cuts have become fashionable. Without question, cutting tax rates helps to get the income tax out of the economic game; zero tax rates certainly would accomplish this end, and otherwise, the lower the better.

But we have to raise a certain amount of revenue to keep the deficit in bounds, and eventually to eliminate it. So tax rates cannot be cut casually.

The Bradley-Gephardt approach has some unique features. It starts with a basic tax of 14 percent that is the only tax for about 80 percent of the population (couples with incomes under $40,000, and single people with incomes under $25,000). The single rate will help to demystify the tax system for this group, which includes those who need the most help to understand it.

Above that level, tax rates increase in two steps. There is a 12 percent surtax on adjusted gross income (that is, total income) from $40,000 to $65,000 for couples ($25,000 to $37,500 for single people); this makes the combined tax rate in that range 26 percent (that is, the 14 percent basic tax plus the 12 percent surtax). The surtax rate increases to 16 percent on income above $65,000 for couples ($37,500 for single persons), making the combined maximum rate 30 percent.

The reduced maximum rate also helps to reduce the intrusiveness of the tax system. High-income taxpayers have the most to gain or lose from tax-related decisions; the higher the tax rate, the greater the incentive to shelter an extra dollar of income, and the less the incentive to earn another dollar. The lower the tax rates, the less these considerations intrude upon the dictates of the market.

Personal exemptions and standard deductions also are part of the tax rate structure. Bradley-Gephardt increases the taxpayer exemptions (for taxpayer and spouse only) to $1,600; other exemptions remain at $1,000. The standard deduction for married couples increases to $6,000; for single persons, to $3,000. With these changes, families of four can earn $11,200 before paying any tax, compared to $7,400 under the current law. This brings the tax-free income level, which has been eroded by inflation, up to the poverty line. Further, the flatter rate schedule and new standard deductions eliminate the marriage penalty for couples with incomes under $40,000, and reduce it substantially at higher income levels.

Cutting tax rates helps the tax system and the economy, but it will not work miracles. The 1981 tax law ignored this important fact; it cut tax rates with no other changes to the law, and assumed that all of our other tax and economic problems would just vaporize. It didn't happen.

The 1981 law was passed in anticipation of rapidly growing federal revenues. Instead we have the monster deficits that in part motivate this reexamination of tax policy.

The 1981 law was expected to enhance voluntary compliance and reduce the use of tax shelters. The Administration even recommended a cut in fiscal 1982 IRS examination funds on these grounds. In fact, however, all signs are that compliance continues to deteriorate. And not only has tax shelter usage boomed, but the supply-side rhetoric apparently carried very little water within the Administration.

So tax rate cuts are only one part of a package to deal the income tax out of the economic game. The 1981 tax law missed this reality, but

Bradley-Gephardt does not.

Repeal of Tax Law Provisions

Legal provisions that reduce taxes under narrow conditions cause trouble. They encourage taxpayers to squeeze what they would do anyway into the tax-favored categories, reducing the government's revenue and the public's respect for the law. And they distort taxpayers' behavior, leading them into activities that are economically inferior to others in the marketplace.

There are three general categories of legal provisions repealed or cut back by Bradley-Gephardt: saving and investment incentives; targeted sectoral incentives; and itemized deductions.

Saving and Investment Incentives. Our nation may well need more saving and investment, but the tax incentives used thusfar have been inefficient or counterproductive. Some of these provisions technically apply more to businesses than individuals, but individuals can and do form businesses for the express purpose of using these provisions to create tax shelters. This obviously reduces public respect for the income tax.

The accelerated cost recovery system (ACRS) and the investment tax credit (ITC) were intended to increase investment by reducing its tax burden. ACRS gives cost recovery deductions for investment in plant and equipment significantly faster than these assets actually wear out. The ITC reduces tax by a fraction of the cost of investment in equipment, thereby in effect paying for part of the investment.

The problem is that in a high tax-rate-system, the cash value of these tax incentives can exceed the tax on the income generated by the investments; in other words, there can be a net subsidy rather than a net tax. Armed with these subsidies, tax planners can reap after-tax profits from relatively or totally unprofitable investments. Further, the federal government loses revenue even on investments that would take place without the subsidy. So rather than increasing productive investment, these incentives may divert funds into unproductive investments, and leave the federal government with less revenue to use in productive ways.

Bradley-Gephardt takes a better route. It repeals the ITC, and replaces ACRS with a simpler depreciation system that mirrors the actual wearing out of plant and equipment. The revenue so gained allows substantial cuts in marginal tax rates. The result is a low tax on investment income rather than a subsidy. It is unlikely that the low tax would discourage much productive investment. In fact, it might encourage more investment, if firms make their investments in the expectation of earning large profits that would be taxed at the high marginal rates of the current law. What the Bradley-Gephardt approach certainly does is cut way back on purely tax-motivated investments that would generate little or no true income. With the tax subsidy gone, investments will have to generate income in the marketplace to be attractive.

Deductions for interest expense are another trouble spot in the current law, because a major element of the classic tax shelter is leverage. Taxpayers borrow to finance tax-favored investments, and deduct all of the interest. Bradley-Gephardt restricts this practice by limiting interest deductions to the amount of the taxpayer's investment income. (There is an exception only for mortgage interest under Bradley-Gephardt's basic 14 percent tax rate.) This interest deduction limit makes the tax system fairer by reducing tax manipulation, and more efficient by directing investment into profitable rather than tax-favored activities.

The exclusion for 60 percent of long-term capital gains is another savings and investment incentive that has gone astray. The exclusion makes some investments more attractive by cutting the tax on their returns more than in half. But it biases investment toward assets that throw off their returns as capital gains--for example, speculative real estate and unproductive collectibles. Conversion of ordinary income into capital gain is a major underpinning of most tax shelters, including the totally unproductive "tax straddles" so prominent of late. Finally, the exclusion for long-term gains discourages taxpayers from realizing short-term gains when it would be economically productive to do so.

Bradley-Gephardt repeals the capital gains exclusion. The tax rate cuts leave the maximum rate on capital gains just above that of the much-heralded tax cut of 1978. There is no relative disadvantage to realizing short-term gains, so taxpayers can realign their portfolios as often as they like. Income in different forms is taxed the same way, and so opportunities for tax sheltering are eliminated.

Other general saving and investment incentives are cut back or eliminated. The net interest exclusion, scheduled to take effect next year, is repealed. The contribution limits on top-heavy pension plans are reduced by one-third. For taxpayers without very large pensions, however, pension treatment will not change, nor will the rules for IRA and Keogh accounts.

There have been allegations that Bradley-Gephardt does not address the nation's capital formation problem, and that it is not an incentive for saving. This allegation misses the point. Bradley-Gephardt provides the strongest and most efficient incentive for saving: low tax rates on all income from capital, however derived. To illustrate: Compare Bradley-Gephardt to the net interest exclusion, a widely heralded saving incentive. The net interest exclusion (if and when it takes effect) will allow couples to exclude from tax 15 percent of their interest income, but not capital income in any other form, and not beyond $6,000 of income. For the top bracket taxpayer, this reduces the tax rate on some interest income from 50 percent to 42.5 percent. In contrast, Bradley-Gephardt reduces the top rate on all income from capital, not just interest and not just up to some ceiling, all the way to 30 percent. So Bradley-Gephardt is clearly superior to the net interest exclusion as an incentive to save.

The fatal mathematics of such saving gimmicks is fairly simple. While such provisions might induce a small amount of new saving, they inevitably also lose revenue for some past saving and for some current saving that would have taken place even without the incentive. So, for example, wealthy couples will receive $450 tax cuts under the net interest exclusion even though they would collect over $6,000 of interest income with no incentive. If the government is short of revenue, this unproductive revenue loss must be made up somehow, and in the final analysis it will happen through tax rates higher than they otherwise need be. But these higher tax rates will discourage all saving--not just some particular form of saving, and not just saving up to some particular ceiling. Worse still, the higher tax rates also will discourage work and investment.

So these saving gimmicks are like drilling holes in the bottom of a leaky boat to let the water out. Bradley-Gephardt takes a better path with a gimmick-free law and low tax rates for all income from capital and labor.

Targeted Tax Incentives. Today's tax law includes numerous targeted investment subsidies. These provisions are designed to provide relative advantages to particular industries or sectors of the economy. They are perhaps the worst intrusions of the tax system on the economic game.

Such targeted incentives distort investment decisions dictated by the market. They reduce taxes on investments that would have been made without the subsidy. When combined with general incentives such as ACRS and the ITC, they can create the most lucrative and unproductive tax shelters. Firms in unfavored but equally deserving industries ask for their own tax breaks to compete for investment capital, further complicating and eroding respect for the tax law. And as the targeted subsidies proliferate in number they tend to neutralize one another, defeating their original purposes.

Bradley-Gephardt repeals or cuts back more than a score of such provisions, including incentives for oil and gas, timber, building rehabilitation, life insurance, banking, DISCs, controlled foreign subsidiary corporations, possessions corporations, corporate farms, construction, credit unions, and low-income housing. Bradley-Gephardt also repeals incentives for research and development, business energy conservation and pollution control investments, finance leasing, collapsible corporations, and tax-exempt private purpose financing. Some of these incentives are more justifiable than others, but none are justifiable in the absolute. They all have flaws in providing windfall gains, complicating the tax law, encouraging tax shelters, and distorting economic activity. The economy will grow faster without these provisions intruding on the economic game.

A final targeted tax incentive, benefitting workers, is the tax exemption for employer-provided fringe benefits. This tax exemption encourages employees to negotiate for compensation in kind--as life insurance, health insurance, legal insurance, and subsidized day care. While all of these forms of compensation may seem desirable, there is no reason why the federal government should intrude between employer and employee to influence how compensation is paid. Workers and employers can decide that for themselves.

Beyond that issue, the tax exemption for fringe benefits causes some serious policy problems. It has become a gaping loophole through which a rapidly increasing proportion of total compensation passes without tax. The more this loophole is used, the smaller the tax base becomes, and the higher tax rates must be; the higher the tax rates, the greater the incentive to pay compensation through fringe benefits. It is a vicious cycle. Further, the tax exemption encourages employees to ask for more of their compensation in the form of insurance than they would otherwise want; some health industry experts say that this is driving up the cost of medical care. And finally, not all workers can get generous fringe benefits; low-wage employees and some of the self-employed are left out. It is unfair that those who don't get fringe benefits have to pay tax on all of their compensation, while those who get fringe benefits don't.

Bradley-Gephardt repeals the exclusion for insurance premium and day-care fringe benefits. Employers and employees will decide on compensation patterns that make more economic sense, tax rates will be significantly lower, and all employees will pay tax on a fairer measure of their income.

Some people argue that the tax subsidies for oil, timber, and banking make the tax system unfair. Economists disagree, explaining that additional resources will flow into the subsidized industries, reducing their rates of return to equal those elsewhere. While this argument is unquestionably theoretically true, it begs some important real-world questions. Unlike in the theoretical models, resources are not perfectly interchangeable, and do not flow instantaneously from one industry to another. Mom and pop cannot fold up their grocery store and whisk it off to Texas to become an oil rig. So despite our theoretical sophistication, we should not dismiss out of hand the alleged unfairness of business tax breaks.

Itemized deductions. Itemized deductions make the federal government share in selected personal expenses. Those taxpayers who itemize have part of their state and local taxes, medical and interest expenses, casualty losses, and charitable contributions paid for by the federal government. Some of these itemized deductions are more justifiable than others, and some are so embedded in our economy that they would be nearly impossible to remove.

Bradley-Gephardt selects the deductions that are least justifiable and also possible to eliminate; those deductions are repealed. They include the sales and personal property tax deductions, and the deduction of nonbusiness interest expense in excess of investment income. The medical expense deduction is limited to expenses in excess of 10 percent of income (compared to 5 percent under the current law). The objective is to eliminate deductions for routine expenses, so that tax rates can be reduced.

Bradley-Gephardt also limits itemized deductions to the 14 percent basic tax; deductions do not apply to the surtax. (The only exception is that interest expense is deductible from investment income for purposes of the surtax.) This restriction eliminates the "upside-down subsidies" in the current law, whereby up to 50 percent of the medical expenses, mortgage interest, and charitable contributions of high-income taxpayers are reimbursed through the tax system, but as little as 11 percent are reimbursed for low-income households.

The Bradley-Gephardt surtax is thus a tax on adjusted gross income, applying only to the 20 percent of the population with the highest incomes. The surtax thus has an extremely broad base, and its rate can be correspondingly low. This is part of the reason why the highest rate can be as low as 30 percent while collecting current law revenues. If itemized deductions are not limited in this way, tax rates must be higher.

Repealing and limiting itemized deductions helps to get the tax system out of the game. Tax considerations enter into many everyday economic decisions when a taxpayer switches from the standard deduction to itemized deductions. Repealing deductions saves some taxpayers the hassle of itemizing, and reduces the tax intrusion into many itemizers' lives. Reducing tax rates, and limiting the rate to which deductions apply, further dials down tax consciousness. These steps are essential to the ultimate objective.

Restoring Fairness

There is no simple, unambiguous definition of fairness in taxation. No flat rate tax is incontrovertibly fair; there are an infinite variety of definitions of income and levels of exemptions and tax rates for a flat tax, and they can't all be fairest. A more progressive tax is not necessarily fairer; confiscation of the incomes of the rich, or anything near confiscation, would violate many people's conceptions of fairness. In the final analysis, fairness is what the people say it is, and the people's voice on such complex and abstract question, absent a national referendum, is inevitably unclear.

So no one plan is objectively the fairest; we must decide how the people would judge any given plan. In my judgment, the public would consider the Bradley-Gephardt package to be fairer than both the current tax law and the alternative proposals put forward to date.

Bradley-Gephardt does not redistribute the income tax burden from one income group to another. The amount of income taxes paid in each income group remains the same. Thus, Bradley-Gephardt makes no broad changes in policy toward the distribution of income. Income distribution is a legitimate issue, but it should be considered separately from the tax structure.

While not redistributing the overall tax burden, Bradley-Gephardt removes inequities within each income group. Two people with the same incomes now might pay very different amounts of tax, because one receives untaxed fringe benefits or invests in tax shelters. Bradley-Gephardt broadens the definition of income to include many types of income not now taxed, so people with the same income would pay more nearly the same tax.

Everyone can agree that people with similar incomes should pay generally similar taxes, which they often don't now; and everyone can agree that tax rates should be as low as possible, which they are not now. So everyone should agree to a tax system with a comprehensive definition of income, fewer opportunities for tax manipulation, and a tax burden distribution identical to what we have now. With these structural issues decided, anyone from any persuasion can argue for tax rates that are more or less progressive. That decision, within reasonable bounds, does not affect the basic tax policy imperative of a broad and water-tight tax base.

One aspect of Bradley-Gephardt that seems necessary for reasonable standards of fairness is its increased exemptions and standard deductions. There has been a near-consensus for at least a decade that families in officially defined poverty should pay no income tax, but the exemptions and zero bracket amounts (ZBAs) that protect poor families from paying income tax have been eroded substantially by inflation since last adjusted in 1978. The 1981 tax law included substantial tax rate cuts, but did not increase the exemptions and zero bracket amounts; so the tax burdens of poor families increased substantially, not just from prior inflation, but from inflation from 1981 through 1984. In its neglect of these problems, the 1981 tax law did have a bias toward the wealthy, who received more than enough in tax rate cuts to compensate them for inflation. Every tax proposal will have to redress this neglect to pass muster.

In sum, while there can be no definitive conclusion, Bradley-Gephardt as a package seems to me to be likely to meet with public approval. It eliminates demonstrable inequities in the tax code, but maintains the distribution of the tax burden that was established in 1981 and that the Congress has refused to change since. While no tax system will ever satisfy everyone's subjective opinion of the proper distribution of income, this one eliminates structural imbalances that are objectively unfair.

Feasibility and Transition

An idea like Bradley-Gephardt has no practical value unless it can be enacted and implemented. Bradley-Gephardt, in my opinion, has the overall design most favorable to prospects for enactment and ease of transition. Nonetheless, there should be no illusions that enactment will be painless and transition easy. Despite the obvious need for such a restructuring, quantum change inevitably involves dislocations and sparks resistance.

Bradley-Gephardt may be more politically feasible than many smaller-scale approaches in at least one important sense. By removing many leakages in the tax base simultaneously, Bradley-Gephardt does allow for a reduction of tax rates. This gives taxpayers who lose important tax preferences some compensation in the form of significantly lower tax rates. In contrast, limited approaches to tax base broadening, such as those of this and the preceding two years, raise little revenue and allow no rate reduction; so taxpayers who lose their preferences are singled out to bear the burden of narrowing the deficit. This process has become increasingly painful, and is now perhaps so painful that it cannot be continued. The Bradley-Gephardt approach may be the only way to make further progress on broadening the tax base and reducing the deficit in the long run.

A second plus of Bradley-Gephardt is its building on the current tax system, rather than altering the structure radically. Progressive rates are retained, as are standard deductions and personal exemptions. This means that the pattern of taxpayers' liabilities will remain much the same. In contrast, other proposals that shift to flat rates and different forms of low-income relief redistribute taxes from one income class, or one group otherwise defined (the elderly, the self-employed), to another.

One of the problems with restructuring the tax system without a tax cut to sweeten the deal is that some people have to pay higher taxes. When taxpayers are blindsided in this way, they have painful adjustments to make. By following the patterns of the current law, Bradley-Gephardt minimizes those tax increases and the adjustments that necessarily follow.

Bradley-Gephardt has a long leg up on the pure flat taxes in that it maintains the broadly used tax deductions for mortgage interest, charitable contributions, and state and local income and property taxes. Lower tax rates reduce the value of these deductions, but lower tax rates are a necessary part of any proposal to get the income tax out of the economic game. Going still further and repealing these deductions would leave homeowners, homebuilders, and charitable institutions with the most painful transition. Retaining these deductions, as Bradley-Gephardt does, makes the necessary restructuring easier.

Proponents of tax bills with no deductions have argued that allowing some deductions makes success less likely. They claim that the first deduction opens the flood gates to a bidding war, and that the end result will be worse than the current law. No one can prove that logic wrong. But many of the same people expect to add mortgage interest and other deductions to their bills at the markup stage to increase their chances of passage. Bradley-Gephardt makes the necessary judgments and compromises about deductions up front. Any additional deductions must be paid for by raising more revenue elsewhere, presumably with higher rates. This "pay-as-you-go" approach should have at least the same chance of success as starting with a "clean bill" as an admitted first offer.

While Bradley-Gephardt makes the necessary changes as easy as possible, change is never painless. Changing the tax system without cutting taxes means that some people have to pay more. The Congress has had to face this reality in its efforts to narrow the deficit over the last three years, and so this is nothing new. But the process of passing Bradley-Gephardt, even with its much lower tax rates, should not be compared with the tax rate cutting in 1981. Leadership will be required to restructure the tax law, much more than just to cut taxes.

Some people argue that no major restructuring can be done now because people have made investments in the last few years in reliance on existing tax preferences. They say that tax reform must wait for five or ten years, when it will be more feasible. This argument ignores the reality that people will continue to act in reliance on existing tax preferences in the next five or ten years. There is no easy time to break with the past. But those same investors knew that several recent presidents, IRS commissioners, and Members of Congress, including Bill Bradley and Dick Gephardt, have called for a broader tax base with less opportunity for abuse. These investors knew the risks they were taking, and those risks were built into the returns on their investments. They have reaped their rewards. Their special interests should not stand in the way of the general interest.

Ten years ago, the American people believed that the federal individual income tax was our fairest tax, and "Made in Japan" was the punchline of a joke. Can we afford to wait ten more years for a fairer, more growth-oriented tax law?

Reference is sometimes made to transition rules that will ease the pain for taxpayers with affected investments. The effectiveness of targeted transition rules should not be exaggerated. An asset whose profit comes mainly from reducing taxes will fall in market value if the tax benefit is taken away. Allowing the current owner to retain his tax benefit for any number of years or until he sells the asset will not prevent this fall in market value. The best that can be done is to enact the restructuring with a prospective effective date, that is, to take effect perhaps two years after enactment. That will give markets time to determine the new values of affected assets, and will give taxpayers notice to reconsider investments in these areas. Some targeted transition rules may help to a limited further degree, but such procedures are no cure-all, and they can complicate the law and create new opportunities for manipulation.

Without any doubt, 1985 will be a year of challenges in economic policy. Tax policy will be one part. The choices will not be easy, but the rewards to wisdom and leadership could be great.

Bradley-Gephardt and the Deficit

Bradley-Gephardt is designed to raise revenues equal to the current law's in its first year (in the current version of the bill, 1985). However, it would raise increasingly more revenue in every succeeding year. This is because it would repeal tax loopholes that are growing faster than the economy, including many tax shelter deductions and employer-provided fringe benefits. This means that Bradley-Gephardt can make a substantial contribution to a long-term deficit reduction program.

Bradley-Gephardt contrasts sharply with some of the competing proposals that would not only lose revenue in their initial years, but would lose increasing amounts of revenue every year into the long run.

Conclusions

Not too long ago, the federal income tax was respected by the American public, and had a relatively limited impact on our daily economic life. Today, however, the income tax has become an integral part of the economic game. Some individuals and many businesses plan their every move around the tax law. This tax consciousness leads to massive economic waste, as valuable resources are devoted to complying with the tax law and minimizing tax liabilities. It is divisive and demoralizing, as some taxpayres watch others cut legal corners to reduce their taxes, and wonder whether they should do the same. And above all, it just isn't fair.

The Bradley-Gephardt bill is one attempt to get the tax system out of the game. It cuts tax rates dramatically, to reduce the incentives for tax manipulation; and it repeals many of the tax law provisions that make manipulation possible. It would remove tax considerations from many economic decisions, and restore market forces to their proper role. The economy should work better, and the popular wrath for the tax system would be dissipated.

The deterioration of our tax system has made the last ten years an exciting time for policymakers and tax specialists. A rapid succession of tax acts has been passed to plug the growing leaks in our tax base and stop the growth of noncompliance and abuse. Other legislation has aimed to increase incentives and stimulate growth. The watershed tax law of 1981, while correct in its intention to reduce tax rates, failed to take the additional necessary steps of broadening the tax base and stopping tax manipulation; indeed, the new law made matters worse. So public respect for the tax law has continued to fall, and noncompliance to climb.

Bradley-Gephardt gives us a chance to end that excitement--by stopping all the high stakes tax sheltering, getting the tax system off of businessmen's minds, and ending the distrust and suspicion of one taxpayer for another. The economic game will become more exciting--with more attention to markets, productivity, competition, and profits. But the tax end of the operation, after the usual frenzy of the legislative process, should become rather dull.

For people of the tax persuasion, the last ten years have been kind of fun. But in the interests of the taxpayer and the federal government, we might give Bradley-Gephardt a close look.

Let's make taxes boring again.

From: Joseph A. Pechman, Ed. What Should Be
Taxed: Income or Expenditure? The Brookings
Institution, Washington, D.C. 1980.

JOSEPH J. MINARIK

Conference Discussion

THE PRECEDING PAPERS provided the background for a conference of economists and tax lawyers held at the Brookings Institution on October 19 and 20, 1978. The discussion was spirited, with advocates and opponents of the expenditure tax relying on theory, applied economics, political judgments, and international perspectives to bolster their positions, while the undecided participants questioned the contentions of both sides. Many issues were clarified, but differences of opinion persisted.

Four broad issues were discussed at the conference. (1) Would the substitution of an expenditure tax for the income tax increase saving and capital formation? (2) Would an expenditure tax be more equitable than an income tax? (3) Would an expenditure tax be easier to administer than an income tax? (4) What are the problems of transition to an expenditure tax? The opinions of the conference participants on each topic will be summarized in turn.

The Expenditure Tax and Saving

Many of those who advocate an expenditure tax as a complete or partial replacement for the individual income tax[1] believe that the rate of national saving is too low and that saving would increase if it were not subject to tax. For each additional dollar saved, potential future consumption would be larger under an expenditure tax than under an income tax, and households would presumably save more to take advantage of the opportunity to consume more in the future. A contrary theoretical argument can be made, however: some taxpayers might choose to save less under the expenditure tax, because less personal savings would be required to attain a planned level of consumption. Thus each household would be faced with two offsetting influences under the expenditure tax: the opportunity to consume more later for each dollar of forgone consumption (that is, saving) today, and the need to save less to achieve any given level of consumption later. Theory cannot predict which force would be stronger and hence whether personal saving would go up or down.[2] That question must be answered by empirical measurement—the aim of the paper by E. Philip Howrey and Saul H. Hymans.

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[1] The treatment of the corporate income tax under an expenditure tax regime is also an issue (see the discussion below).

Howrey and Hymans wrote against a backdrop that included a recent paper by Michael J. Boskin.[3] In sharp contrast to most earlier research, Boskin found a relatively large and significant elasticity of saving with respect to the real after-tax rate of return. This would indicate that a higher rate of return to saving, such as would be produced by a change from the income tax to an expenditure tax, would significantly increase saving. Boskin's analysis was an attempt to explain consumption in the years 1929 to 1969 on the basis of a number of variables, including the unemployment rate, household wealth, the inflation rate, and disposable personal income, as well as the long run expected real after-tax rate of return on saving. Howrey and Hymans performed a similar time series analysis and found no significant evidence of a positive effect on saving. Much of the discussion of the response of saving to the rate of return dealt with the technical merits of the two studies.

[2] Total national saving will increase, however, if the change from an income tax to an expenditure tax shifts some of the government's tax receipts from the taxpayers' later years to their earlier ones. The government must then increase public saving in the early years if the time pattern of government purchases of goods and services is to remain unchanged. Thus, even though private saving decreases, total national saving will necessarily increase. The crucial point is that the government increases its surplus to maintain the original time pattern of public spending during the transition from income to expenditure taxation. Martin Feldstein, "The Rate of Return, Taxation and Personal Savings," *Economic Journal*, vol. 88 (September 1978), pp. 482–87.

[3] Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, vol. 86 (April 1978), pt. 2, pp. S3–S27. For an earlier estimate of the response of saving to a change in the rate of return, see Colin Wright, "Saving and the Rate of Interest," in Arnold C. Harberger and Martin J. Bailey, eds., *The Taxation of Income from Capital* (Brookings Institution, 1969), pp. 275–300.

One of the difficult problems about this type of analysis is the choice of the precise variable to be explained. Given Boskin's definition of consumption, his implicit concept of saving was close to that used in the flow-of-funds accounts, which includes consumer spending on housing and other durables. Howrey and Hymans were critical of Boskin's use of this concept on the ground that expenditures on consumer durables are not available for business capital formation. They used as the basis for their analysis a new concept called *personal cash saving*. This concept excludes from saving durable goods expenditures (which are included in the flow-of-funds definition of saving) and the changes in reserves of private pension and insurance plans (which are included in the national income accounts definition of saving).

The views of the conference participants regarding the proper definition of saving were mixed. Some argued that pension and insurance reserves could be loaned to businesses for productive investment, so that those items should be included in saving. Others pointed out that consumer investment in durables (such as housing) is as productive as business investment for ultimate consumer use (such as rental housing); they felt that durables should be included in the saving variable. Some agreed that personal cash saving is the appropriate variable but were concerned that its small size—an average of only about 0.2 percent of disposable personal income in 1951–74—makes it an unpromising goal for policy. Howrey and Hymans countered that the year-to-year variance of the personal cash saving rate is almost as large as that of flow-of-funds saving, and therefore any new policy that influences the variation of personal cash saving can have a substantial effect on capital formation. Furthermore, they found that saving is not responsive to the rate of return even when a flow-of-funds or national accounts concept is used.

A second concern was the rate-of-return concept. All the conferees agreed that the real after-tax rate of return is the appropriate variable but that measurement of this concept is difficult. Boskin's rate-of-return variable was estimated "from an adaptive expectations model of price expectations, truncated after 8 years, with varying speeds of adjustment,"[4] but the precise method of calculating this variable was not explained before or during the conference. Howrey and Hymans found no rate-of-return variable other than the particular formulation used by Boskin to show a positive and significant interest effect on saving in his model. This led the discussion to focus on the interest rate.

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[4] Michael J. Boskin, "Taxation, Saving and the Rate of Interest," pp. S5–S11.

Though data limitations forced both Boskin and Howrey-Hymans to restrict themselves to one explanatory rate-of-return variable, many of the participants felt that an array of potential interest rates is needed to capture all the opportunities available to the saver—including the passbook saving rate plus an appropriate liquidity premium, and the interest rate at which households borrow. Given the data limitations, therefore, the choice of the interest variable was critical. Howrey and Hymans tested a number of interest rates as the basis for their regression and found that the Baa corporate rate had the greatest effect on saving. They adjusted for expected inflation by subtracting from the interest rate the mean expected inflation rate as measured by consumer surveys conducted by the Survey Research Center of the University of Michigan.[5] To allow for changes in taxation, the average marginal personal income tax rate on dividend and interest income was used.

One conferee argued that both Boskin and Howrey-Hymans, in computing their after-tax rate of return on saving, did not adequately reflect the complexities of the tax laws—in particular the exemption of many forms of saving (especially pensions and insurance) from current taxation. Others criticized Howrey and Hymans for using a one-year measure of inflationary expectations rather than an average for a longer period.

The participants also stressed the weakness of the basic data used in both papers. The small number of observations (resulting from the use of annual data) limited the number of explanatory variables that could be employed and the degrees of freedom that remained, clouding all the results. Boskin's data period was longer than that of Howrey and Hymans, but even so, some conferees felt that the Howrey and Hymans sensitivity tests of the Boskin results suffered from a shortage of degrees of freedom. Several conferees stated that any clear improvement over the results presented at the conference would have to come from panel data that traced how households changed their consumption and saving behavior as economic conditions changed. Such data are not now available, nor are they expected to become available in the foreseeable future, and research using such data would be quite complex.

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[5] Howrey and Hymans obtained similar results using inflation rates measured by the consumer price index and by the national income accounts consumption deflator.

Technical questions aside, the conferees had much to say about the implications of the interest elasticity of saving—whatever it might be—for tax policy in general and the expenditure tax in particular. Most felt that the United States would be better off with more business capital formation, although they disagreed on how much more was needed. Less widely accepted was the notion that an increase in personal saving would result in an increase in capital formation. As already noted, Boskin's saving concept includes investment in several forms of consumer durables that do not add to industrial capacity; increased saving in this form would not add to productivity in the business sector. Furthermore, personal saving in the form of cash or other liquid assets might be lent to borrowers from abroad; this would not increase capital formation at home.

Several conferees expressed a preference for less radical changes in the tax system than an expenditure tax—for example, larger investment credits, faster depreciation, or more exemptions for selected forms of saving. Such policies, it was claimed, would increase rates of return and thereby increase saving and capital formation to the extent that saving is elastic with respect to the rate of return. It was also noted that, without changing the tax system, saving and finance for investment could be directly increased by reducing the federal government's budget deficit.

Several conferees argued that even if the elasticity of personal saving with respect to the rate of return were zero, the substitution of an expenditure tax for an income tax would increase welfare through a more efficient allocation of consumption over a lifetime. They pointed out that the appropriate measure of the welfare effect of a tax exemption for saving is not the elasticity of saving (which is an expenditure elasticity) but rather the elasticity of future consumption (which is a quantity elasticity). The same rate of saving would yield greater future consumption because of the higher after-tax rate of return; the additional after-tax consumption in later years is a measure of the welfare gain. Thus a change to an expenditure tax would encourage individuals to reallocate consumption and saving over their life cycles (that is, save more early in life to pay for greater consumption later) and thereby would improve welfare even if personal saving did not increase.

It was agreed that this argument was correct at the theoretical level. But some conferees pointed out that, as compared with an income tax, the expenditure tax would increase taxes on the young and the old (because needs generally are higher relative to income at those stages of life and saving most difficult) while reducing taxes on people of middle age (when income generally reaches its highest level and personal needs are not affected by family formation or retirement).[6] It is not obvious that this shift in relative tax burdens is equitable, and proponents of the income tax claimed it would be politically unacceptable.

Both the capital formation and welfare effects of expenditure taxation would depend in part on the tax rates that were ultimately adopted. Since an expenditure tax is theoretically an income tax with a deduction for saving, the revenues under a comprehensive expenditure tax would be lower than the revenues under a comprehensive income tax with the same tax rate. No one can guess how far from the theoretically correct base an actual expenditure tax might turn out to be, but several participants argued that the deviations would be at least as large as those experienced under the income tax. If government revenues were to be held constant, other taxes would have to be increased or the expenditure tax rates would have to exceed the income tax rates. One conferee pointed out that the additional taxes or higher tax rates could reduce capital formation; another noted that a higher tax rate on labor income coupled with the recent payroll tax increases would reduce work incentives. Thus until the expenditure tax rates were known, the net welfare effect would be unpredictable.

The Expenditure Tax and Equity

The advocates of the expenditure tax stressed its efficiency advantages, while the opponents put more emphasis on equity. The discussion of equity dealt with six topics: the choice of the appropriate tax base, the time perspective of the tax system, the relative treatment of

[6] This is mainly a timing question: a proportional expenditure tax would tax equally in present-value terms consumption streams of equal present value regardless of the timing of income and consumption flows.

different types of income, the progressivity of the system, implications for the distribution of wealth, and the tax treatment of gifts and bequests.

The Choice of an Appropriate Tax Base

The traditional equity arguments for expenditure taxation are based on a notion of the relative social value of income and consumption. Income, this view holds, represents a contribution to society's output, whereas consumption is a withdrawal or use of that output. On this basis, income is to be favored and encouraged, while consumption should be penalized and discouraged. This view is now considered fairly old-fashioned and even puritanical, but a more subtle version has survived: some conferees support consumption as the appropriate tax base because it is the best measure of the taxpayer's enjoyment or satisfaction.

Income tax advocates generally respond that saving out of income yields its own satisfaction, particularly because it accumulates as a store of wealth and economic power. Richard Goode argued in his paper that savings increase a person's power to consume marketable output and therefore do not lessen his capacity to pay taxes. According to this view, ability to pay tax is no different whether a taxpayer chooses to save or consume his income.

Other aspects of the choice rest on empirical grounds. Nicholas Kaldor, who revived academic interest with his book *An Expenditure Tax,* published in 1955, argued that many taxpayers, while maintaining comfortable living standards, can reduce their *taxable* income to trivial levels through tax preferences or dissaving from accumulated wealth. For this reason he and others supported William D. Andrews's proposal to use the expenditure tax as a supplement to the income tax, not as a replacement. Other participants argued that expenditure is in fact the best measure of a taxpayer's permanent or lifetime income. They claimed that income may fluctuate from year to year, but households tend to consume according to the income they expect to receive over the long run.

One participant argued that people with equal options (that is, equal potential consumption) should pay equal tax. Under this view, with a truncated year-by-year approach, accretion is the correct tax base. But the consumption base is preferable if a lifetime approach is used, because individuals with equal potential consumption would be subject to the same present-value tax. If gifts and bequests are considered, this participant contended, the consumption base is no longer correct unless it is broadened to include such transfers.

The Time Perspective of the Tax System

The time perspective of the income tax is explicitly annual. While short-term income averaging is available to reduce the tax penalty of progressive rates on fluctuating income, the aggregation of income over somewhat longer periods is still not necessarily a good measure of long-term well-being. Although consumption is a purely current concept, it is much more stable than income, and expenditure tax advocates believe that it is a better measure of long-term well-being. In a world of certainty, if all income is consumed over a lifetime and there is no tax on saving and no gifts or bequests, the present value of the lifetime consumption expenditures of two persons with the same lifetime income (also discounted to the present) is the same regardless of when they consume their incomes. Thus the expenditure tax has a lifetime perspective.

At the conference, supporters of the expenditure tax claimed that the lifetime perspective is a major advantage of that tax. Opponents of the expenditure tax argued that the lifetime perspective is a dubious advantage in a world of extreme political and economic uncertainty. In their view, a person's income history taken much beyond a modest averaging period has very little effect on current economic behavior. Though one year might be too short a horizon for tax purposes, they contended that a lifetime is too long.

Treatment of Various Types of Income

Expenditure tax advocates claim that income from different sources would be treated more uniformly under an expenditure tax than under the income tax because the consumption base does not depend on the source of income. Most of the conference participants agreed that a theoretically correct expenditure tax (or a theoretically correct income tax) would in fact be more neutral among income types than the present imperfect income tax. However, a number of participants insisted that preferences could easily be carried over into an expenditure tax for the same reasons that they were inserted into the income tax and that other preferences for particular items of consumption would creep in.

Progressivity

In theory, it should be possible to design a rate schedule for an expenditure tax that achieves the same degree of progressivity as the present income tax. But there are no reliable data on savings rates by income class.[7] Even if such data could be obtained, there would be considerable uncertainty as to how the savings rates would be altered by the substitution of an expenditure tax for an income tax. Further, tax preferences and loopholes might turn out to be larger or smaller at any given income class under the expenditure tax. Thus there is little basis for choosing a rate schedule for an expenditure tax that would achieve the desired degree of progressivity. One conferee pointed out that the efficiency gains from an expenditure tax are quite sensitive to the tax rates chosen, so that the flexibility for choosing a rate schedule to achieve distributional goals is limited.

Another consideration is that, to achieve the same yield, expenditure tax rates will at least appear higher than those under the income tax. Assuming no savings, a 50 percent income tax rate is equivalent to an expenditure tax rate of 100 percent; on the same assumption, the current top bracket income tax rate of 70 percent would be equivalent to a 233 percent tax rate in consumption. Some conferees considered it unlikely that the public would understand or tolerate marginal tax rates over 100 percent. On the other hand, proponents of the expenditure tax argued that the tax rates could be expressed on a gross basis (that is, as a percentage of consumption plus the amount of the tax), even though this would understate the true tax rates on consumption. If the stated top bracket tax rate on consumption had to be held below 100 percent on a net basis, the loss in revenue and progressivity would make the tax unattractive to many analysts.

Implications for the Distribution of Wealth

By the very nature of the consumption tax, taxpayers who save large fractions of their income will, over time, be able to accumulate wealth. Several conferees raised the possibility that the tax would increase the concentration of wealth.

A basic question is whether the shift to an expenditure tax would significantly increase the tax-saving opportunities of high-income people. Some argued that the present income tax preferences for saving, such as the provisions for private pensions, individual retirement accounts (IRAs), and Keogh plans, are used mainly by people at the top of the income distribution. Reinforcing this view, the best available data indicate that most of the population saves very little and has very small or negative net worth. The expenditure tax, however, would allow taxpayers to defer tax on any type of saving, thereby broadening the opportunity for saving. Taxpayers with small amounts of wealth might have particularly strong incentives to save more. The result might be to increase wealth holdings among households of comparatively modest means.

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[7] The lack of data is the result of the inevitable failure of sample surveys to successfully account for the upper tail of the income distribution and of the absence of savings information from existing tax returns.

Opponents of the expenditure tax argued that it would have just the opposite effect. They contended that savings are small in the lower part of the income distribution because needs are large relative to income, not because the rate of return is too low. The shift to an expenditure tax would not increase after-tax rates of return for low-income taxpayers very much (because they are already subject to low tax rates), so that the effect on their saving would probably be minimal. If saving should increase among upper-income taxpayers, before-tax rates of return would be bid down, thus reducing the savings incentives for those with modest incomes. Some expenditure tax advocates agreed with this proposition.

Thus the benefits of a switch to an expenditure tax could accrue largely to high-income taxpayers with above average savings, who might accumulate even more wealth than under the present system. Some conferees were therefore concerned about the distribution of wealth if an expenditure tax were enacted, but there was little agreement on what should be done about it.

A final wealth consideration concerned the transition to an expenditure tax. Wealth held at the time of enactment of an expenditure tax would be accumulated from taxed income. Full taxation of such wealth when consumed plus the prior income tax would be a greater burden than the taxes that would be paid on the consumption of wealth accumulated after the expenditure tax was enacted. At the same time, the full exemption of prior wealth accumulations would validate the past use of tax loopholes to achieve tax-free consumption, which many expenditure tax advocates decry. Further, the exemption of accumulated capital at current market prices would forgive the tax liability on any appreciation that had not been realized when the income tax was in effect. This issue was regarded by the participants as a major roadblock to the adoption of an expenditure tax, but there was no agreement on how to solve the problem.

Tax Treatment of Gifts and Bequests

The treatment of gifts and bequests under an expenditure tax was one of the most controversial topics discussed at the conference. As was noted earlier, the identity of the present value of lifetime aggregates of consumption of persons with equal discounted incomes holds only if there are no gifts and bequests. Accordingly, several conferees recommended that under an expenditure tax gifts and bequests be regarded as consumption of the donor. Such treatment is also justified on the ground that, since the donor has the option of making the gift or bequest, doing so must give him satisfaction or he would choose to consume more himself. Other conferees pointed out that this technique would in fact amount to double taxation—the gift would be counted as consumption of the donor and taxed to him; then it would be counted as a receipt of the donee and taxed again when it was consumed. They felt that this would inordinately encourage consumption at the expense of saving for the purpose of making gifts and bequests. Some of this group preferred that the gift or bequest not be considered consumption of the donor, but be taxed only to the donee when it was consumed.

A lively debate ensued over the equity implications of taxing a gift in that way. Some of the conference participants felt that it would result in wholesale tax avoidance by wealthy families through transfers from members in higher tax rate brackets to those paying at lower rates, but one participant argued that taxpayers would try to minimize the total tax by dispersing their gifts among many low-rate taxpayers, thus tending to equalize wealth. Other conferees argued that the tax on both donor and donee was not offensive because both could derive utility from the same gift—one by giving it and the other by consuming it—and that the donee would not be taxed so long as he did not consume the gift. One lawyer lamented that taxation of the donor would continue many of the problems in the present estate and gift tax laws, including the use of generation-skipping transfers and the need for distinguishing between gifts and support for dependents. It was pointed out that, in all these matters, the definition of the taxable unit would be crucial in determining whether a transfer was in fact a gift, a support payment, or a reward for services rendered.

A different element in the debate on taxation of the donor or donee under an expenditure tax was the role of the present estate and gift taxes. One conferee suggested that transfers need not be included in the expenditure tax base at all, because the estate and gift tax, possibly redesigned for the new tax environment, could perform the function of taxing such transfers. He contended that the expenditure tax would deal with continuous flows of expenditure but could not properly handle discrete transfers that were bunched into a single year. Others responded that transfers should be included in the bases of both taxes; they argued that the expenditure tax would tax the utility derived from giving or receiving the gift, whereas the transfer tax was a tax on the right given by society to transfer property.

A final suggestion was for an annual or periodic wealth tax as an alternative or supplement to the inclusion of transfers in the expenditure tax base. Such a tax would explicitly deal with wealth concentrations, and one conferee argued that a wealth tax would not alter incentives to consume or give. But others feared that any increase in the taxes on wealth, by the adoption of a wealth tax or by an increase in the estate and gift taxes, would greatly reduce the incentives of wealthy people to save. If such taxpayers decided that consumption would be the best use of their wealth, the outcome would be a drawing down of the nation's capital stock.

Administration and Measurement under an Expenditure Tax

Expenditure tax advocates claim that a tax based on consumption would be easier to administer than the present income tax and that the measurement of the appropriate economic flows would be easier and subject to fewer anomalous results. These claims are sometimes presented in a simplified form using the familiar Haig-Simons definition of income as consumption plus the change in net worth. The reasoning is that a measure of change in net worth is needed to determine income but not to measure consumption. In contrast, income tax advocates point out that consumption is income less saving. It follows that it is necessary to measure saving to determine consumption, so that the consumption tax has all the administrative problems of the income tax plus those that involve the measurement of saving. Some of the flavor of this controversy (greatly simplified here) carried over into the detailed discussion of the merits of the two taxes on administrative grounds.

The discussion in this section is divided into three parts. The first examines two possible simplifications of the expenditure tax that attracted considerable attention at the conference: the prepayment option for investments and the equivalence of a consumption tax and a wage tax. The second describes several features of the expenditure tax that are alleged to be inherently simpler than the corresponding features of the income tax. The third discusses the areas in which the income tax is alleged to be simpler than the expenditure tax.

Ways to Simplify the Expenditure Tax

It has long been assumed that the measurement of saving under an expenditure tax would require a considerable amount of record-keeping and would greatly complicate the tax return. First, in the year an investment was made, the amount invested would be deducted from receipts to determine taxable expenditure. In each subsequent period, the returns on the investment would be included in receipts. Later, when the investment was sold, the sales proceeds would also be included in receipts. This process, known as the cash flow approach, was taken to be relatively cumbersome because one of the operations —the reporting of the purchase of assets—is not required under the income tax.

In recent years it has been suggested that the procedure could be simplified by allowing the taxpayer to forgo deductions for purchases of assets and to ignore the sales, at his option.[8] Because the present value of an asset is the discounted value of its future receipts, the lump sum tax payment at the time the asset was purchased would presumably equal the discounted value of the future tax payments omitted, thus leaving the government indifferent to taxpayers' choices.[9] Beyond the fact that there would be no need to account for investment income, this "prepayment" option has an interesting implication: it would treat identically two taxpayers identically situated in terms of their investment *opportunities* rather than their investment *outcomes* over a lifetime (given the tendency of consumption to reflect a lifetime or "permanent" income).

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[8] U.S. Department of the Treasury, *Blueprints for Basic Tax Reform* (Government Printing Office, 1977), pp. 113–39.

[9] It is assumed the expenditure tax is a proportional tax or, if it is progressive, the taxpayer remains in the same tax rate bracket.

The prepayment option (or the ex ante view of taxation) was one of the most discussed topics of the conference. David F. Bradford, under whose supervision the Treasury's *Blueprints for Basic Tax Reform* was prepared, defended the prepayment option in his paper, while Michael Graetz opposed it in his.

Some advocates of the expenditure tax supported Bradford's position for two reasons. First, the prepayment option would greatly simplify tax compliance and administration. Second, they regarded the ex ante view of tax equity as more appropriate than the ex post view—that is, that income opportunities are a better basis for taxation than actual outcomes. The net effect would be a tax on endowments from a lifetime perspective, which they felt was ideal. One participant noted that the prepayment option might increase saving and capital formation if investors set aside reserves at the time investments were made in order to pay the expenditure tax on unprofitable ventures.

Many conference participants, however, agreed with Graetz. For some, this position was grounded on their perceptions of the principle of fairness in taxation. Several argued that taxation based on outcomes is widely accepted and that the public at large would not understand a tax based on opportunities. They also felt that ex ante taxation of investments with substantial variation of returns would be inequitable. Others disagreed with the lifetime perspective implicit in the ex ante view of tax equity; they believe that, even if an annual accounting period is too short, a lifetime is much too long for tax purposes.

Still others pointed out that, because the federal budget imposes a liquidity constraint year by year, the government would not be indifferent among different streams of tax revenue with the same present value. Bradford responded that prepayment would probably accelerate the receipt of revenues, thereby increasing rather than decreasing the government's options, and that in any event the government could meet its constraints by altering its borrowing behavior.

It was also pointed out that the prepayment option could have a negative rather than a zero net effect on government revenues over the long run. Although marginal investments can be expected to have a zero return, there are many inframarginal investments with positive expected returns. The election of the prepayment option for those investments would reduce government revenue relative to a mandatory cash flow treatment. Furthermore, since taxpayers would make the prepayment election with a year's worth of information when tax returns were filed, they would choose the option that would be to their advantage and thus reduce the government's revenue below the level to be expected from a random outcome. Finally, unless the prepayment option were modified, it would in effect allow short-term gains to be realized tax free.

Beyond these problems, the prepayment option could create extensive opportunities for tax avoidance and manipulation by taxpayers. One participant pointed out that two persons, for example parent and child, might organize a joint oil exploration and development enterprise. One of the participants—most likely the parent—would do the initial exploratory drilling of selected areas in the field at a low expected payoff and would use the cash flow option; the other would capture the high returns of subsequent development drilling and would use the prepayment option and pay a minimal amount of tax. Alternatively, any individual or group might set up a corporation heavily capitalized with preferred stock (taking the cash flow option) and lightly capitalized with common stock (taking the prepayment option). Another type of avoidance scheme would be for one person to use two interest-bearing accounts, one to be taxed under the prepayment method and the other under the cash flow method. Any money put into the cash flow account at the beginning of the year would generate a deduction, and if the funds were then moved to the prepaid account for the remainder of the year, the interest would not be taxable. The funds would then be transferred at the beginning of the next year to a cash flow account and the process repeated.

Bradford acknowledged that these avoidance opportunities would exist, but he argued that each arrangement has a counterpart under the present income tax and that the expenditure tax problems would be no worse. He felt that such problems could be dealt with through regulations or other procedures. For example, it should be possible to take care of the mineral exploration and preferred–common stock arrangements by regulations for financial transactions at less than arm's length, and the coordinated use of separate cash flow and prepaid accounts could be stopped by withholding on interest receipts. But other participants expressed the judgment that the regulatory and administrative complexity of these procedures would be considerable. Many thought that a cash flow approach would have to be used for most important financial transactions. Some felt that the rejection of the prepayment method weakened the case for the expenditure tax, while others felt that a cash flow tax would be readily administrable.

Another potential simplification of the expenditure tax derives from the theoretical equivalence, discussed in the tax literature, of the expenditure tax and a tax on wages and salaries. If the two were in fact equivalent, a wage tax would be an attractive substitute for an expenditure tax since it would be easier to administer. It was generally agreed, however, that the equivalence held only in the aggregate and only under specified conditions and that the divergence between consumption and earnings in individual cases was far too great to justify considering a wage tax to be a proxy for an expenditure tax.

Advantages of the Expenditure Tax

Proponents of the expenditure tax cited several ways in which it would be inherently much simpler than the income tax. The first is the elimination of differences in the tax treatment of the various forms of income from capital. Under the income tax, capital gains are treated differently from interest, dividends, or rent; corporate income is taxed differently from unincorporated business income; and income from mineral extraction, timber, farmland, and low-income housing are all given some form of preferential treatment. An alleged advantage of the expenditure tax is that, at the personal level,[10] there would be no distinctions among different forms of property income. Each dollar that entered into consumption would be taxed the same as every other, regardless of its source, because distinctions based on sources of income would be harder to justify. This was seen as providing several advantages: efficiency would be served by the removal of incentives to realize income in preferred forms; equity between those who can and cannot alter the form of their income receipts would be improved; and the tax system would be easier to administer. Further, the difficulties of measuring business income, including such perennial problems as accounting for depreciation and inventories, would be eliminated.

Critics of the expenditure tax generally acknowledged these theoretical advantages but doubted that they could be achieved in practice. They pointed out that the groups who obtained passage of depletion allowances for minerals and exclusions for capital gains under the income tax would attempt to obtain the same or similar advantages under an expenditure tax. Paul R. McDaniel pointed out that if charitable contributions were excluded from the expenditure tax base, a taxpayer would pay the same tax as he would if he had put the money in the bank for himself. He feared that charitable organizations would therefore use their influence to obtain an exclusion of more than 100 percent for charitable contributions in order to provide some tax incentive to the donors.[11] Similarly, the rapid amortization of low-income housing under the income tax could be replaced by a deduction of more than 100 percent of the amount of the investment under the expenditure tax. The issue boiled down, therefore, to a question of whether any expenditure tax that would be enacted would be closer to, or further from, the ideal than the present income tax is; the conferees were divided in their opinions.

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[10] The incorporated vs. unincorporated business aspect is discussed below.

Another advantage of the expenditure tax is that a consumption tax *base* is automatically adjusted for inflation. Since property income would be taxed only when it was consumed and then in full, an adjustment of the tax base for inflation would be unnecessary. In contrast, inflation adjustments are extremely complicated under the income tax because it is necessary to allow for price level changes over various periods of time in computing depreciation, inventory costs, changes in the value of outstanding debt, and other elements of taxable income. It might be desirable to index the personal exemptions, standard deductions, and tax rate boundaries for inflation, but this would be just as easy under the expenditure tax as it would be under the income tax.

A final advantage of an expenditure tax is that, in principle, there would be no need for a corporate income tax to supplement it. Corporate income would be taxed when distributed and consumed or when realized in the form of capital gains and consumed. Without a corporate tax, the complications of accrual accounting for depreciation and inventory valuation would be eliminated, and the distinction between the taxation of incorporated and unincorporated business income would be removed.

Nevertheless, even the expenditure tax supporters disagreed about the desirability of eliminating the corporate tax. Some felt that the simplicity and efficiency benefits of eliminating the tax are very large and therefore worth pursuing. A second group was concerned about the distributional consequences of eliminating the tax; they felt that repeal would provide windfall gains to shareholders and therefore favored something like the current tax, at least for foreign stock owners. A third group thought that the repeal of the corporate tax was unlikely, even though it would be appropriate; this group sought a corporate tax that would be as inoffensive as possible conceptually and operationally, but that would at least maintain a facade of corporate taxation to satisfy the political constraints. One possibility was the cash flow tax proposed by the Meade committee in the United Kingdom—a tax based on the notion of a partnership and sharing of risk between the government and the business enterprise. Another was a kind of integration of the individual and corporate income taxes, with the corporate tax considered to be withholding on behalf of the individual taxpayer.

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[11] Of course, value judgments on this issue differ; another conferee expressed concern that the Congress might *not* provide such a subsidy for philanthropy.

Opponents of the expenditure tax felt that the question of the corporate tax cannot be easily resolved. It was pointed out that the elimination of the corporate tax would increase the revenue needed from the expenditure tax and thus require a much higher tax rate. The risk-sharing idea of the Meade committee was criticized because it would provide an implicit government share in corporate enterprises that was higher than in unincorporated firms. One conferee stated that if a corporate tax were required for political or other reasons, the burden should be on expenditure tax advocates to explain the type of tax that would be needed and whether it would negate the conceptual advantages claimed for the expenditure tax. Another conferee was quick to reply that the political need for a corporate tax is not a unique disadvantage of the expenditure tax—the corporate tax is an essential element of an income tax system.

Disadvantages of the Expenditure Tax

Although the expenditure tax would be simpler than the income tax in some respects, it would be more complicated in others.

Housing. Housing is perhaps the most difficult problem. The theoretically correct treatment of housing under the income tax is to include the rental value of the house, net of interest, depreciation, and maintenance expenses, in taxable income. Few countries rigorously tax the rental value of owned homes because it is extremely difficult to measure and would require payment of tax on income not received in cash.

Because the use of housing is a form of consumption, the net rental value of owner-occupied homes should be included in an expenditure tax base. An alternative solution, suggested by Michael Graetz, is to regard the purchase of a house as a taxable event and to include it in its entirety in the expenditure tax base (the prepayment option). Later, when the house was sold, only the gain on the sale would be included as a taxable receipt. The same treatment could also be applied to durable goods purchases.

Few of the conference participants believed that the legislative process would reach the correct result under either approach. Congress is no more likely to tax imputed rent under an expenditure tax than under the income tax. The entire purchase price of a house would probably not be taxable upon purchase, because taxpayers would be liable for large amounts of tax at the same time that they were committing themselves to large contractual expenditures. This bunching problem complicates the treatment of housing under the expenditure tax even more than under the income tax. In effect, housing purchases under the expenditure tax are analogous to the realizations of long-term capital gains under the income tax—the first are long-term expenditures that would be taxable in one year, while the second are long-term income that is taxed in one year. The bunching problem has led to the adoption of preferential treatment for capital gains and would be likely to lead to generous preferences or complete exemption for housing under an expenditure tax.

Defenders of the expenditure tax responded that there are workable solutions for the housing problem. Some suggested a simplified method of calculating the net rental value of an owner-occupied home on the basis of its purchase price, for example, imputing the value on the basis of an average rate of return. Some would adjust the imputed net rent for the aggregate inflation rate (rather than rely on periodic reassessments of each individual house), while others would not change the taxable rent after the time of purchase. One conferee suggested that a fraction of each mortgage payment (corresponding to the ratio of down payment to total purchase price) be added to taxable receipts each year, to avoid taxing the down payment in full in the year of purchase.

The conference participants were not satisfied with any of the suggested formulas for taxing housing and other durables. It was conceded that this was one of the most difficult problem areas in tax policy, and many of the conferees felt that the case for or against the expenditure tax should not depend on our ability to devise a workable solution. The expenditure tax advocates claimed that the difficulties of handling housing and other durables under the expenditure tax could hardly be considered a serious disadvantage in light of the widely acknowledged failures of the income tax in those areas.

Monitoring of transactions. A second inherent complexity of an expenditure tax is the need to devise methods of checking asset transactions. A traditional argument is that complete balance sheets would be necessary for this purpose. Participants argued that the incentive to conceal a transaction is much larger under an expenditure tax than under the income tax; under the income tax, only a fraction of the sale price—the gain or loss—is included in the calculation of taxable income, but the entire proceeds would be included in receipts under an expenditure tax. It was also pointed out that it would be essential to obtain individual balance sheets during the transition to an expenditure tax in order to prevent the accumulation of cash balances that could be used to pay for subsequent consumption on a tax-free basis.

Some defenders of the expenditure tax contended that records of asset holdings or full balance sheets would not be necessary. They based their arguments largely on the work of William D. Andrews, who has explained how a cash flow expenditure tax could be based entirely on current income flows and without regard to asset stocks.[12] Under the Andrews model of a cash flow tax, it would not be necessary to report receipts and payments in any more detail than under the income tax. Some conferees maintained that, to take advantage of the deduction for saving, asset purchasers would have every incentive to report their costs and that this would prevent sellers from attempting to conceal their side of the transaction. They further maintained that balance sheets are mainly useful in accounting for holdings of assets, which would not be taxable in any event, but they would be of no use in identifying sales of assets, which would be taxable.[13]

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[12] William D. Andrews, "A Consumption-Type of Cash Flow Personal Income Tax," *Harvard Law Review*, vol. 87 (April 1974), pp. 1113–88.

Some conferees suggested that it might be possible to limit the record-keeping to certain specified types of assets. Such a register might be prepared as part of the transition procedures and for the administration of any wealth tax that would accompany the expenditure tax. One conferee pointed out that an initial register plus annual reporting of sales and purchases might be sufficient for enforcement purposes. Such a register could also be used for controlling the emigration of people with assets accumulated from tax-exempt funds (see below for a discussion of the problem of emigration). However, there was no real consensus on just how thorough the asset record-keeping would have to be under an expenditure tax.

International aspects. The third set of issues that would be encountered in administering an expenditure tax would be the treatment of emigration and immigration and of domestic consumption by foreigners and foreign consumption by U.S. citizens. These issues are not confined to the expenditure tax; they are inherent in any tax that might be adopted in an income tax world. Many procedures have been developed over long periods of time to enable income tax nations to handle international income flows, but it is not clear how an expenditure tax nation would fit in.

Opponents of the expenditure tax pointed out that the inclusion in the tax base of income received and taxed outside the country and not saved would be unorthodox and awkward. If Americans earned income overseas, it would theoretically not be proper to credit foreign income taxes paid against the domestic expenditure tax. One possibility would be to allow a credit only for value-added tax or other consumption taxes levied in foreign countries. When foreigners earned income here without spending, their liability would be zero under the tax as defined for Americans; some other form of tax would have to be imposed if it were felt that the taxation of such income was appropriate.

Unless some form of emigration tax were collected, it would be highly profitable for Americans to earn and save in the United States under an expenditure tax and then go to an income tax country to do their spending. The opposite problem would be the taxation of spending by immigrants from income already taxed in the country of origin. It was also pointed out that an expenditure tax world would leave developing countries with far less tax revenue than they now have, because much of the income earned in such countries is transferred to the developed countries to be spent there.

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[13] David Bradford also pointed out that other enforcement devices were described in the Treasury's *Blueprints for Basic Tax Reform*, pp. 114–44 and 181–216.

Several conferees concluded that the emigration problem could best be handled by taxing all wealth taken from the United States as if it were consumed at that time, with exemption provisions for temporary emigration. One participant suggested that a list of assets be required from all taxpayers and that a portion of the total value of the specified assets be held as a bond to ensure against permanent tax avoidance through emigration. Other conferees were concerned about the international political implications of a large tax levied upon emigration, since it could be made to appear much like the fees some nations now impose to discourage emigration of political dissidents. Paul McDaniel suggested that taxation on a citizenship rather than a residence basis would minimize tax avoidance through emigration. Michael Graetz, who felt that emigration from the United States would be much less of a problem than it might be from other nations, suggested that explicit remedies might not be needed. Many conferees felt that our knowledge of these problems was far too limited and that much more research was needed to reach firm conclusions. But the expenditure tax advocates felt that satisfactory compromises could be written into the law and negotiated with other nations.

Accumulation of wealth. A final area of complexity that would be created by an expenditure tax would be the need for the revision of the taxation of wealth. Some form of taxation of exempt accumulation would be necessary to relieve the concern of many of the conferees (proponents as well as opponents of the expenditure tax) that the substitution of an expenditure tax for the income tax would increase the concentration of wealth. Such a tax could be an explicit annual or periodic net wealth tax, or the treatment of gifts and bequests as if they were items of consumption, or simply improved gift and estate taxes.

The conferees were divided on the form that such a tax should take, but they did agree that any solution would involve greater complexity than at present. Gifts and bequests could be taxed under the expenditure tax itself only if some form of averaging were provided. Averaging for bequests would be limited to carry-backs and would of course involve compliance by persons other than the donor. Explicit wealth taxation would involve its own complications of valuation and assessment (plus the possible need for a constitutional amendment). And if reliance were placed on the present estate and gift taxes, considerable improvement would be needed to meet the requirements of an expenditure tax regime.

Transition to an Expenditure Tax

It is widely recognized that transition to an expenditure tax would be troublesome; this topic was therefore given a good deal of attention at the conference. A related topic was the Kaldor-Andrews supplementary expenditure tax proposal, which can be used either as a permanent supplement to the income tax or as a transition mechanism between the income tax and an ultimate expenditure tax system.

Treatment of Accumulated Assets

As mentioned earlier, a major issue of the transition to an expenditure tax is the treatment of savings that were accumulated and taxed under the income tax. If such accumulations were taxed again when consumed, they would bear a heavier burden than would later accumulations from tax-exempt savings. The equity implications of alternative approaches have already been discussed, but there are also difficult problems of rule making, compliance, and verification.

The population group most seriously affected by the enactment of an expenditure tax would be the retired elderly, who would not benefit from the tax exemption for savings, because they would be drawing down their assets to finance current consumption. (Indeed, the elderly might even lose income before taxes if before-tax rates of return on savings declined.) But various forms of saving, such as contributions to pension, Keogh, and IRA accounts, are already exempt from the income tax. These produce tax outcomes that are not unlike those under the expenditure tax itself. Thus a blanket exemption of the accumulated assets of the elderly would give many of them a windfall. Graetz maintained that special rules for previously taxed assets might be needed only for the currently retired and those close to retirement. For younger people the extent of double taxation would be small because most saving accumulations take place at, or after, middle age.

It was generally agreed that it would be inequitable simply to exempt the value of accumulated assets at the time the expenditure tax went into effect. Many wealthy people could maintain their consumption levels out of their assets for many years without paying expenditure tax. Furthermore, there could be a double deferral for unrealized capital gains, which are not taxed under the income tax and which would not be taxed under the expenditure tax until they were consumed. Graetz's solution to that tax avoidance problem was to exempt only the cost basis of accumulated assets. He also suggested that taxpayers who wished to be taxed on their unrealized capital gains under the income tax system (to avoid higher consumption tax rates later) could be permitted constructive realization for such gains without actually selling the assets. Other participants, citing the recent deferral to 1980 of the effective date of the carryover-of-basis provision enacted in 1976, pointed out that the calculation of basis of assets during transitions is difficult for administrative and political reasons. They expected that if an expenditure tax were enacted, there would be an exemption for the total market value of assets accumulated up to the effective date, which would leave a wide loophole for people with large wealth holdings.

Tax evasion during the transition would also be possible by the manipulation of portfolios prior to the enactment of the expenditure tax. A taxpayer could liquidate assets (with or without a taxable gain) before the effective date of the expenditure tax, hide the cash, and then claim a deduction for saving by repurchasing the same or other assets after the tax went into effect. Such evasion could be prevented by requiring taxpayers to file comprehensive personal balance sheets on the effective date of the expenditure tax, including cash balances. Alternatively, the balance sheets might be required long enough in advance of the effective date to make the hoarding of cash for the entire period unattractive. Sven-Olof Lodin suggested that the latter course could be the beginning of record-keeping for any wealth tax to be imposed simultaneously with the expenditure tax. He added that workable transition procedures were critical because the announcement of the expenditure tax could have drastic effects on asset values.

A somewhat different effect of the announcement of an expenditure tax was suggested by another participant. Taxpayers would have incentives to accelerate consumption before the effective date of the expenditure tax and to postpone income receipts until later. Some procedure might be devised to account for such actions, but no one came up with any practical solution.

A Supplementary Expenditure Tax

The discussion of the supplementary expenditure tax, which was proposed by Andrews and supported by Kaldor, centered on equity as well as administrative problems.

A traditional argument for a supplementary expenditure tax is that it would tax those who avoid income tax through preferences in the current law and through dissaving. One participant argued, however, that a supplementary expenditure tax proposal might have peculiar distributional effects. An expenditure tax confined to the higher tax brackets would permit wealthy taxpayers to reduce their tax liability by saving a large fraction of their income, while less affluent taxpayers would not have the same opportunity. A second participant pointed out that the coexistence of two progressive taxes might result in excessive tax liabilities unless the combined burdens were taken into account.

With regard to administration, some conferees saw the supplementary expenditure tax as a suitable transition mechanism to a full expenditure tax. They felt that the supplementary tax would show how a full tax could be administered, what the tax rates might be, and how the tax would affect saving and the economy. But concern was expressed that the tax authorities would be hard-pressed to administer two different personal taxes simultaneously. One participant argued that the imposition of the expenditure tax problems on top of the problems of the income tax would give the administrators the worst of both worlds. Another participant tentatively suggested that an expenditure tax might coexist with the income tax as a kind of minimum tax, but it was pointed out that the minimum tax is a preference tax based on income tax principles and that an expenditure tax could not fill that role.

Summary and Conclusions

It is not surprising that the conference did not produce a consensus on the feasibility or desirability of expenditure taxation. Many of the problems have been discussed in the technical literature for many years, and most of the participants had formed their opinions before the conference. Moreover, the resolution of the major issues depends on value judgments that can hardly be changed in a two-day meeting.

Nonetheless, the conference provided a useful forum for the exchange of ideas among people who have opposing views of the expenditure tax, and it clarified their principal differences. The blending of economic and legal considerations was particularly helpful. It gave the economists an opportunity to appreciate the problems of implementing an expenditure tax, and lawyers an opportunity to understand the economic arguments for and against expenditure taxation.

An important issue for the economists is whether the substitution of an expenditure tax for the income tax could have a significant effect on personal saving. Many participants felt that the available data do not support the contention that the interest elasticity of saving is high, though they were not prepared to agree that it is zero. Proponents of the expenditure tax stressed that, even if personal saving did not increase, the reallocation of saving over the lifetime of individuals would increase economic welfare and efficiency.

The discussion of equity brought out a number of important points. The lifetime perspective of the expenditure tax was thought to be a great advantage by its proponents, whereas its opponents felt that a much shorter accounting period (though not necessarily as short as a year) was more appropriate for tax purposes. The close association between a tax on endowments and an expenditure tax was duly noted, but most of the participants were persuaded that the tax system should continue to be based on outcomes. It was agreed that the distributional effects of an expenditure tax on various income, consumption, and wealth groups cannot be predicted on the basis of currently available data. To prevent an inordinate increase in the concentration of wealth and economic power, effective estate and gift taxes or periodic wealth taxes were regarded by most of the participants as essential supplements to an expenditure tax.

There was no meeting of minds on the administrative feasibility of an expenditure tax, but a number of technical issues were clarified. It was agreed that there is no easy way to treat housing and that whatever solution emerged would probably be as unsatisfactory under the expenditure tax as it is under the income tax. The use of the prepayment option as a method of taxing housing, consumer durables, and other assets was explored; the consensus was that elaborate rules and regulations would be needed to prevent the manipulation of prepayments and postpayments. The treatment of wealth accumulated before the transition and the treatment of the untaxed wealth of emigrants from the United States were acknowledged to be extremely troublesome.

Thus any decision on whether or not to implement an expenditure tax rests both on scientific questions, which remained unresolved but are subject to further research, and on value judgments, on which there was and most likely will be no consensus.

From: Henry J. Aaron and Michael J. Boskin, Eds.
The Economics of Taxation. The Brookings
Institution, Washington, D.C. 1980.

JOSEPH J. MINARIK *Brookings Institution*

Who Doesn't Bear the Tax Burden?

TAX EQUITY has received considerable public attention in recent years. Tax preferences were an important issue in the 1976 presidential election, and the winner promised fundamental reform of the income tax to broaden the personal income tax base. The public perception of the issue was influenced by analyses that showed graphically how much the various tax preferences reduced liability in different income classes.[1] This paper expands upon those analyses in three ways. First, it presents results showing the average effective tax rates paid at all income levels according to the tax schedule used and the number of exemptions claimed. Second, it shows which tax prefer-

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[1] See Joseph A. Pechman, "Individual Income Tax Provisions of the Revenue Act of 1964," *Journal of Finance*, vol. 20 (May 1965), pp. 247–72; Joseph A. Pechman and Benjamin A. Okner, "Individual Income Tax Erosion by Income Classes," in U.S. Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Compendium of Papers, Joint Economic Committee Print, 92 Cong. 2 sess. (Government Printing Office, 1972), vol. 2, pp. 13–40; Joseph A. Pechman and George F. Break, *Federal Tax Reform: The Impossible Dream?* (Brookings Institution, 1976); and Joseph A. Pechman, ed., *Comprehensive Income Taxation* (Brookings Institution, 1977).

ences are claimed by taxpayers with tax liabilities widely different from those characteristic of their income class and household status. Third, it also analyzes the effects of tax preferences used by groups of households according to the degree of difference between their taxes and the average. Comparisons can thus be made between groups of tax returns with similar use of tax preferences at different income levels and between others with different use of tax preferences at the same income levels. This analysis will be based on the Brookings 1970 MERGE file.[2]

Determination of Average Effective Tax Rates

The public seems to be more interested in vertical equity—the fair differentiation of tax burdens borne by various income classes—than in horizontal equity—the equal treatment of families in the same income class. The latter question is the focus here, and evidence on variation in taxes at a given level of income will be presented. The public's fascination with vertical equity may arise because equal taxation of equals is a generally endorsed principle, while the standard for the appropriate treatment of unequals is a source of continuing and passionate disagreement. From a more pragmatic viewpoint any broadening or narrowing of tax preferences that did not change the distribution of average effective rates would not change total revenue, which is presumably set according to public sector needs rather than distributional preferences. This horizontal equity approach can provide insights to the need for and effects of tax reform independently of redistributional questions.[3]

A number of provisions of the tax law cause differences in tax liabilities at any given income level with no intervention by the taxpayer. Two taxpayers with the same incomes might pay taxes according to different tax rate schedules and claim different standard deductions and personal exemptions. These differences reflect the collective judgment that families of different sizes or marital status are not identically situated even if their incomes are identical. For that reason separate results are presented here for taxpayers filing each of the four different types of returns (married, filing jointly; married, filing separately; single; head of household). Furthermore, these results are based on a new income measure called standard taxable income that is used to compute average effective tax rates. Standard taxable income is defined as adjusted gross income plus excluded sick pay and moving expenses and the excluded half of long-term capital gains, less the appropriate standard deduction under the tax law in question, less the total amount of personal exemptions for the taxpayer(s) and dependents. These last two adjustments control for the varying family sizes and filing statuses of different taxpayers.

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[2] The MERGE file is the result of linking responses to the March 1971 Current Population Survey with those from tax returns for 1970 on computer-readable magnetic tape. Working papers on the construction of the MERGE file are available from the author.

[3] Two other issues in tax policy concern the relative treatment of incomes growing at different rates and of incomes that fluctuate around any trend. I do not deal with such distinctions between current and "permanent" income.

Deviations in effective tax rates around the average are measured relative to regression equations, one for each type of tax return. This approach avoids computational difficulties that would result from measuring deviations in effective tax rates relative to the average for an income bracket. With broad brackets and a progressive rate structure the average effective rate would be expected to increase from the bottom of each interval to the top. Thus the average for the entire interval would not be an appropriate standard for the extremes unless the interval were very small. With small income intervals, of course, the number of tax returns within that interval would be reduced, and therefore the sampling variation of the mean would increase.

The alternative chosen here, to estimate the average effective tax rate through a set of four regression equations, circumvented the problems of progressivity within income intervals and the sampling variation described above.

A simple single natural logarithmic transformation provided the best fit of effective tax rates (that is, liabilities, T, as a percentage of STI) to STI.

$$T/STI = a + b\ ln(STI),$$

where T is tax liability and STI is standard taxable income. In order to obtain a satisfactory fit, it was necessary to eliminate returns with negative standard taxable income and to truncate to zero the negative taxes of those low-income tax returns eligible for negative taxes under the refundable earned-income credit. The regression results are shown

Table 1. Estimates of Average Effective Tax Rates
Dependent variable: tax/standard taxable income

	Coefficient[a]				
Type of return	*Constant*	*Natural log of standard taxable income (thousands of dollars)*	R^2	F[b]	*Standard error of estimate*
Single	0.3614 (0.0014)	0.0397 (0.0002)	0.6546	25,785.60 (1; 13,604)	0.036
Joint	0.3972 (0.0024)	0.0543 (0.0005)	0.2010	11,945.62 (1; 47,491)	0.105
Separate	0.5467 (0.0158)	0.0831 (0.0035)	0.6377	569.54 (1; 322)	0.069
Head of household	0.3632 (0.0035)	0.0457 (0.0006)	0.6129	5,304.64 (1; 3,349)	0.042

Source: Brookings 1970 MERGE file, projected to 1977.

a. Figures in parentheses are standard errors.

b. Figures in parentheses are degrees of freedom.

Table 2. Distribution of Tax Returns by the Relationship of Tax Liabilities to the Average, 1977

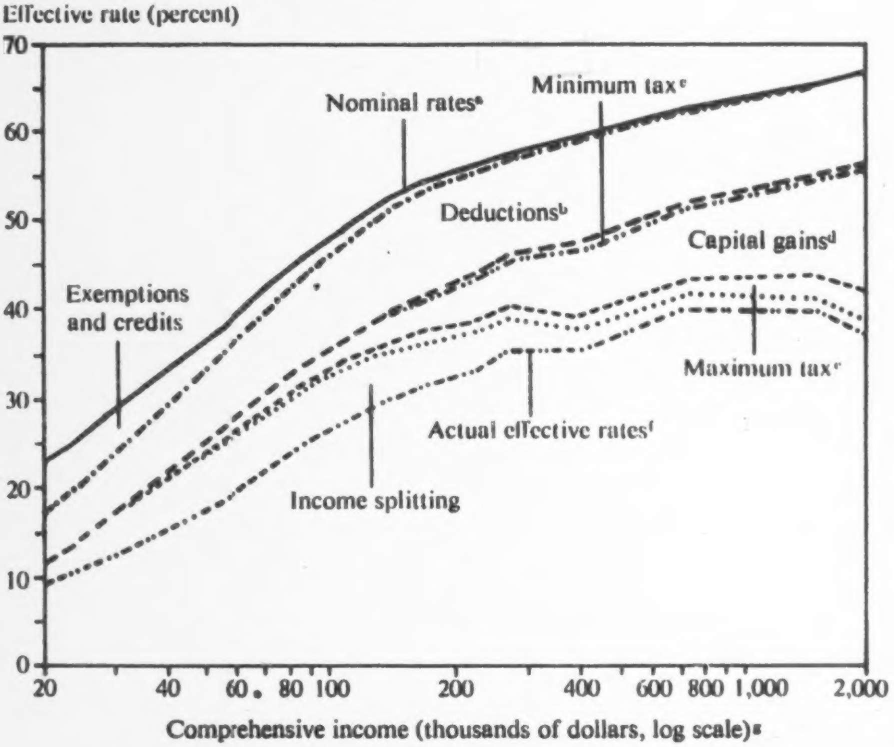
Tax rate as a percent of average tax rate for various income levels	*Number of returns (millions)*	*Percent of all returns*
0	3.1	4.2
0–24[a]	0.7	1.0
25–49	1.4	1.9
50–74	2.5	3.4
75–99	8.8	12.0
100 and over	56.8	77.5[b]
Total	73.2	100.0

Source: Brookings 1970 MERGE file, projected to 1977. Data are rounded.

a. Tax is 25 percent or less of the average effective rate for the income level but greater than zero.

b. The reason that over 50 percent of returns show taxes greater than average is that (1) the distribution of taxes as a percentage of the average is skewed toward zero, as explained in note 4 in the text, and (2) the regression equation used to estimate the average effective rate at each income level underestimates the actual mean because it is fit on the basis of the square of the deviation of each observation from the mean, rather than on the deviation itself.

Figure 1. Influence of Various Provisions on Effective Rates of the Federal Individual Income Tax, 1976: All Taxpayers



Source: Brookings 1970 MERGE file, projected to 1977. Curves are smoothed.

a. Rate schedule for married couples filing separate returns applied to comprehensive income.

b. Standard and itemized deductions plus dividend, sick pay, and moving expense exclusions.

c. Special calculation for tax preference items, except excluded net long-term capital gains. The net effect of this category was calculated by eliminating the minimum tax on preference items and including these items in comprehensive income to be taxed at the regular rates.

d. Combined effect of the alternative tax calculation for taxpayers with capital gains and excluded net long-term capital gains.

e. Effect of maximum marginal tax rate of 50 percent on earned taxable income.

f. Includes reductions for retirement and foreign tax credits, which are not shown separately.

g. Comprehensive income is the sum of adjusted gross income, excludable sick pay, excludable dividends, excludable moving expenses, and tax preference items as defined in the Tax Reform Act of 1969, including excluded net long-term capital gains.

in table 1,[4] and the distribution of tax returns by the relationship of tax liability to the average is shown in table 2.

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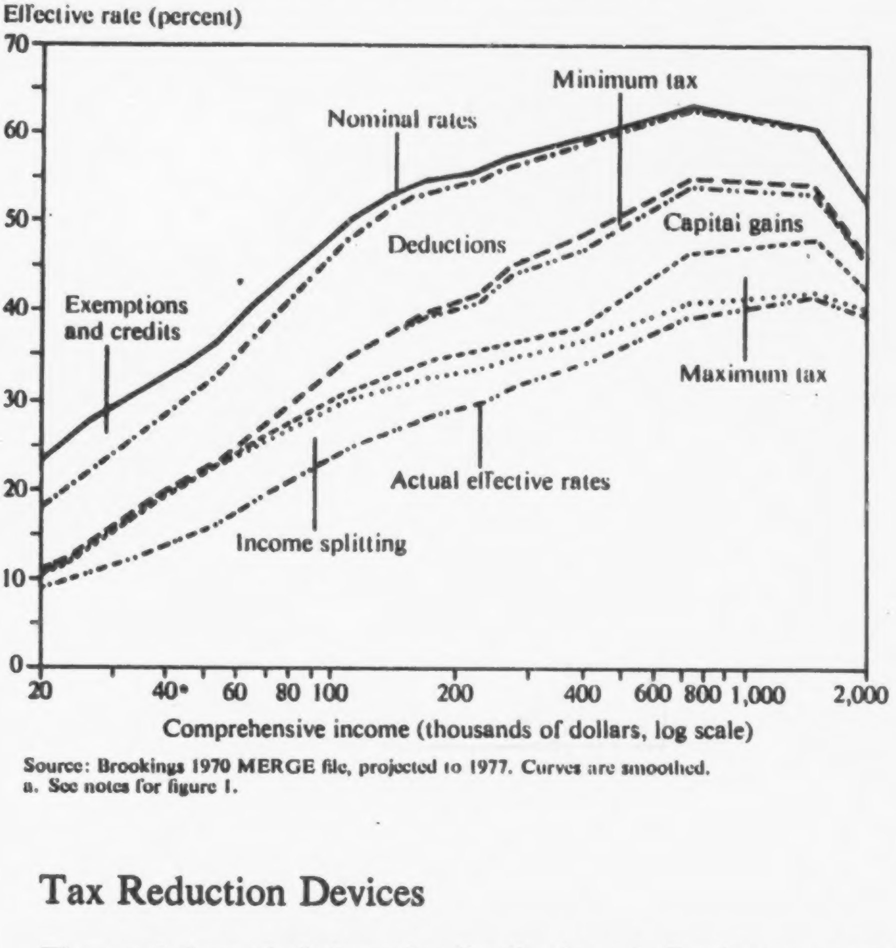
[4] The distribution of effective tax rates is such that there is a maximum value (that which results from taking the standard deduction with no exclusions) but no minimum other than zero. Thus the distribution tends to be truncated at the highest possible tax rate, and the regression curve underestimates the average rate somewhat. The result here is that the group selected as paying approximately the average effective rate includes returns paying somewhat less, and the group selected as paying less than average in fact pay even somewhat less than stated.

Figure 2. Influence of Various Provisions on Effective Rates of the Federal Individual Income Tax, 1976: Taxes within 5 Percent of Average[a]



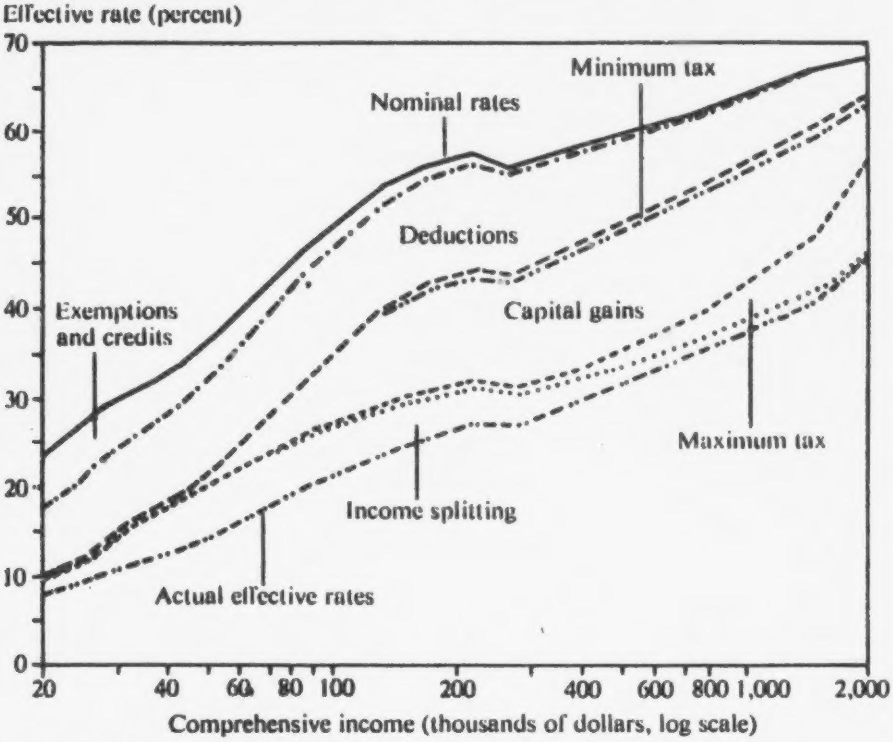
Source: Brookings 1970 MERGE file, projected to 1977. Curves are smoothed.
a. See notes for figure 1.

Tax Reduction Devices

Figures 1 through 6 show the distribution of effective tax rates by income class that would prevail if no deductions or exemptions whatever were permitted; they also show the change due to reinstating each preferential feature one by one until the final result is tax liability under 1976 law.

Figure 1 shows the effects of the individual tax features for all tax filers. The personal exemptions and personal credits in the law reduce taxes significantly at the lower income levels but become relatively less important as income rises. Personal deductions have a large impact at all levels, including lower incomes where the standard deduction is prevalent. Tax preference items excluded from the ordinary tax but subject to the minimum tax have a perceptible effect only at upper

Figure 3. Influence of Various Provisions on Effective Rates of the Federal Individual Income Tax, 1976: Taxes between 75 and 100 Percent of Average[a]



Source: Brookings 1970 MERGE file, projected to 1977. Curves are smoothed.
a. See notes for figure 1.

income levels;[5] the maximum tax on earned income has a similar impact. Income splitting reduces taxes by the largest relative amounts at moderately high income levels and less at the highest and lowest incomes.

The effect of the capital gains preference is striking.[6] While it has no perceptible effect on effective tax rates for households with comprehensive income below about $25,000, the exclusion of one-half of realized long-term gains (and the lower alternative tax rate) reduces taxes by sharply increasing amounts as income rises until it is the second most important revenue-reducing feature for the highest in-

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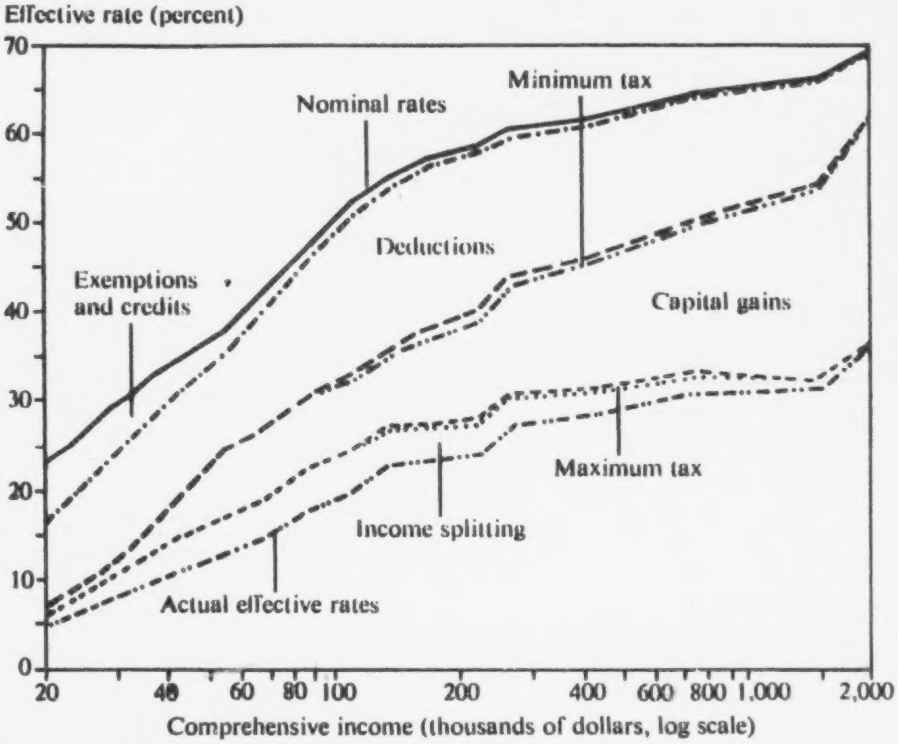
[5] Not including excluded long-term capital gains.

[6] This paper does not deal with the issue of the inflationary component of capital gains. See Joseph J. Minarik, "The Size Distribution of Income During Inflation," *Review of Income and Wealth*, series 25 (December 1979), for estimates of the effect of inflation on after-tax incomes by income class.

Figure 4. Influence of Various Provisions on Effective Rates of the Federal Individual Income Tax, 1976: Taxes between 50 and 75 Percent of Average[a]



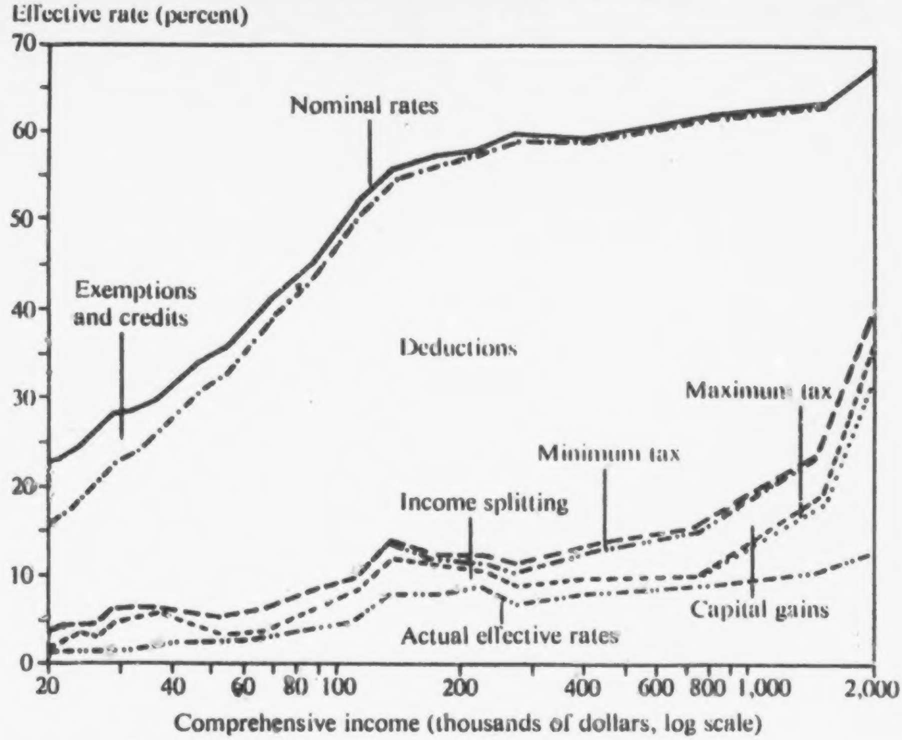
Source: Brookings 1970 MERGE file, projected to 1977. Curves are smoothed.
a. See notes for figure 1.

come returns. This pattern suggests the possibility that capital gains play a leading role in cases of highly successful minimization of tax liability by upper-income taxpayers.

Figure 2 reinforces this conclusion. It shows that the upper-income taxpayer with liabilities near the average for his income class uses the capital gains preference less than do all of those with high incomes. By contrast, he uses the maximum tax on earnings more than do all those with high incomes, indicating that the high-income taxpayer with average liability receives a relatively large fraction of his income from labor. Below about $70,000 of income it is clear that the average taxpayer uses virtually no tax reduction devices beyond deductions and exemptions.

Figures 3 and 4 show effective rates for two other subgroups of the population: those whose taxes are between 75 and 100 percent, and 50 and 75 percent of the average for their income class, respectively. For upper-income returns in these groups it is clear that the capital

Figure 5. Influence of Various Provisions on Effective Rates of the Federal Individual Income Tax, 1976: Taxes between Zero and 25 Percent of Average[a]



Source: Brookings 1970 MERGE file, projected to 1977. Curves are smoothed.
a. See notes for figure 1.

gains exclusion and the alternative tax are of primary importance. These preferences reduce the effective rates on taxpayers in the highest income classes by 20 percentage points for households with liabilities 25 to 50 percent of the average for their income class—more than all itemized deductions. The maximum tax has less effect for this group, a fact that reveals that these households have little earned income.[7] Income splitting also becomes relatively less important for lower tax rate groups, while tax preference items other than capital gains become more important. The tax reduction devices used at income levels below about $70,000 are again restricted largely to the various itemized deductions.

Figures 5 and 6 show the tax-reducing features used on returns

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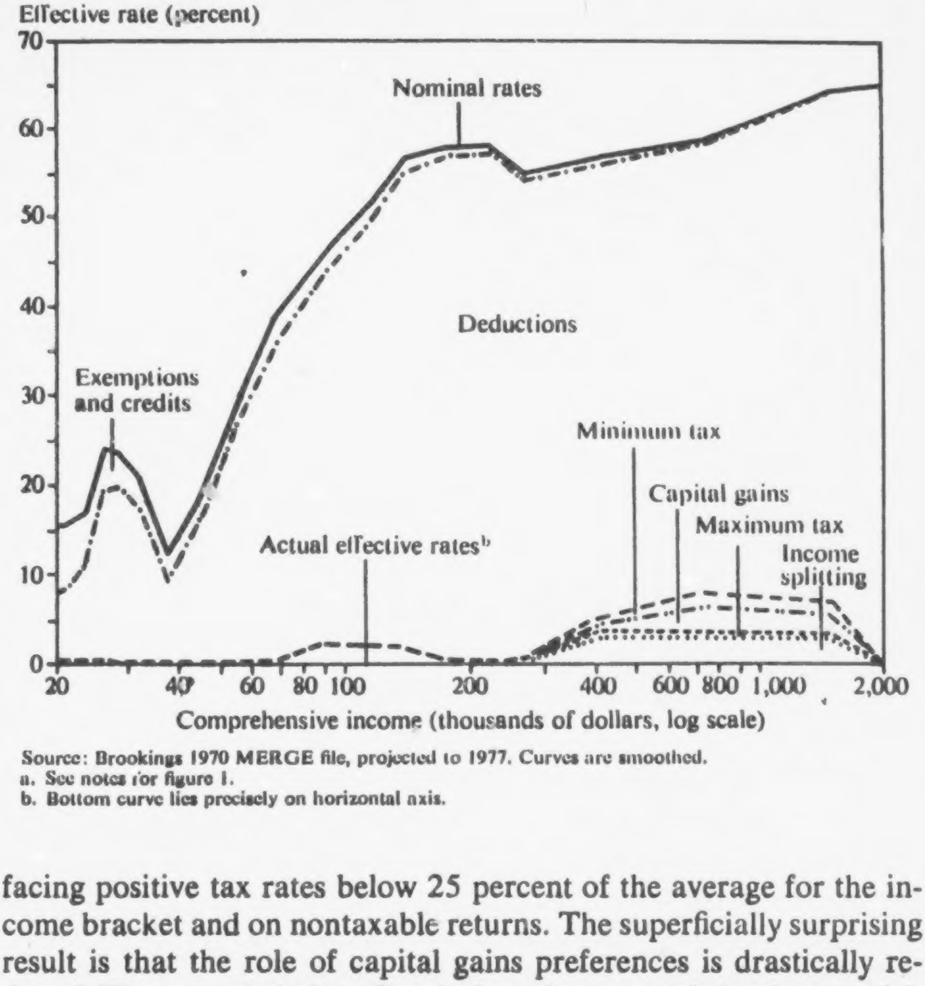
[7] Alternatively they may have earned income that is ineligible for the maximum tax because they also have large amounts of excluded long-term capital gains. This "poisoning" feature has been repealed in the Revenue Act of 1978, effective in tax year 1979.

Figure 6. Influence of Various Provisions on Effective Rates of the Federal Individual Income Tax, 1976: Nontaxable Returns[a]



Source: Brookings 1970 MERGE file, projected to 1977. Curves are smoothed.

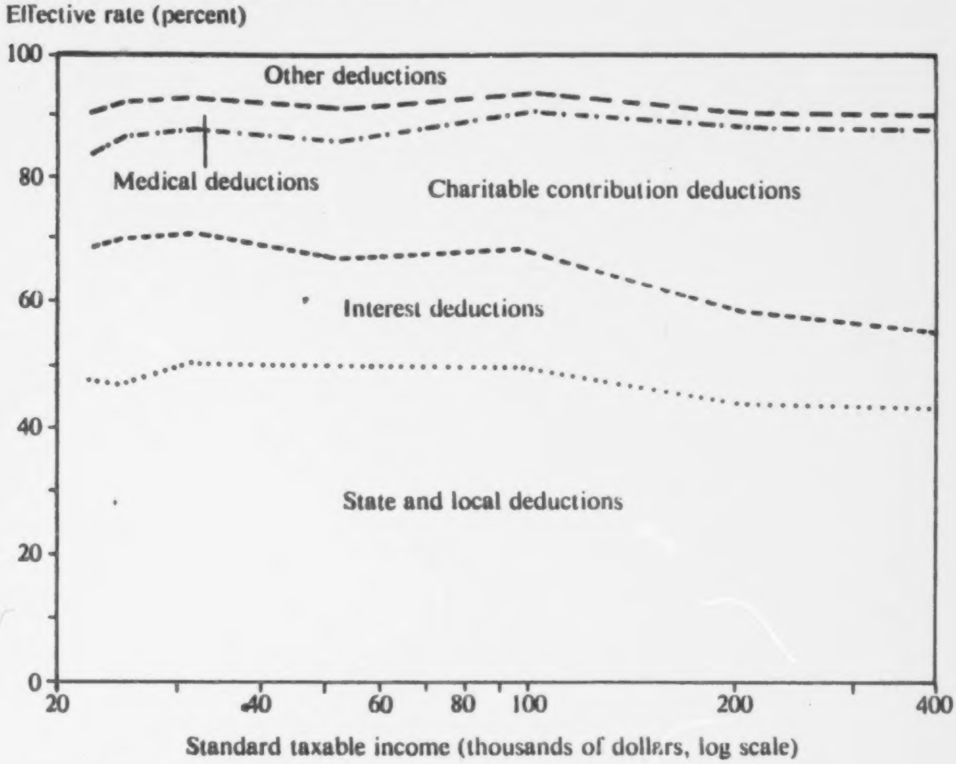
a. See notes for figure 1.

b. Bottom curve lies precisely on horizontal axis.

facing positive tax rates below 25 percent of the average for the income bracket and on nontaxable returns. The superficially surprising result is that the role of capital gains preferences is drastically reduced. The overwhelming effect is that of personal deductions, which by themselves reduce effective tax rates by 50 percentage points or more at the highest income levels. The only other appreciable effect is that of capital gains, which is less than 10 percentage points for both groups. The dominance of personal deductions below $100,000 of income is virtually unchanged. These results make it clear that different taxpayer groups with varying effective rates of tax make dramatically different use of different tax reduction devices.

A remaining question is the composition of the personal deductions taken at different income and effective tax rate levels. Figures 7–9 classify itemized deductions among five categories: medical,

Figure 7. Selected Itemized Deductions as a Percentage of Total Itemized Deductions: Taxes Greater than Average



Source: Brookings 1970 MERGE file, projected to 1977.

charitable, interest, state and local taxes, and all other. The results indicate that the relative use of different itemized deductions also varies significantly among households depending on whether their liabilities are close to or much below the average for their income bracket.[8]

Comparisons among the effective tax rate classes can best be made by broad income groupings. Between about $20,000 and $200,000 the low effective tax rate group shows a greater relative use of medical, charitable, and (with less consistency) miscellaneous deductions

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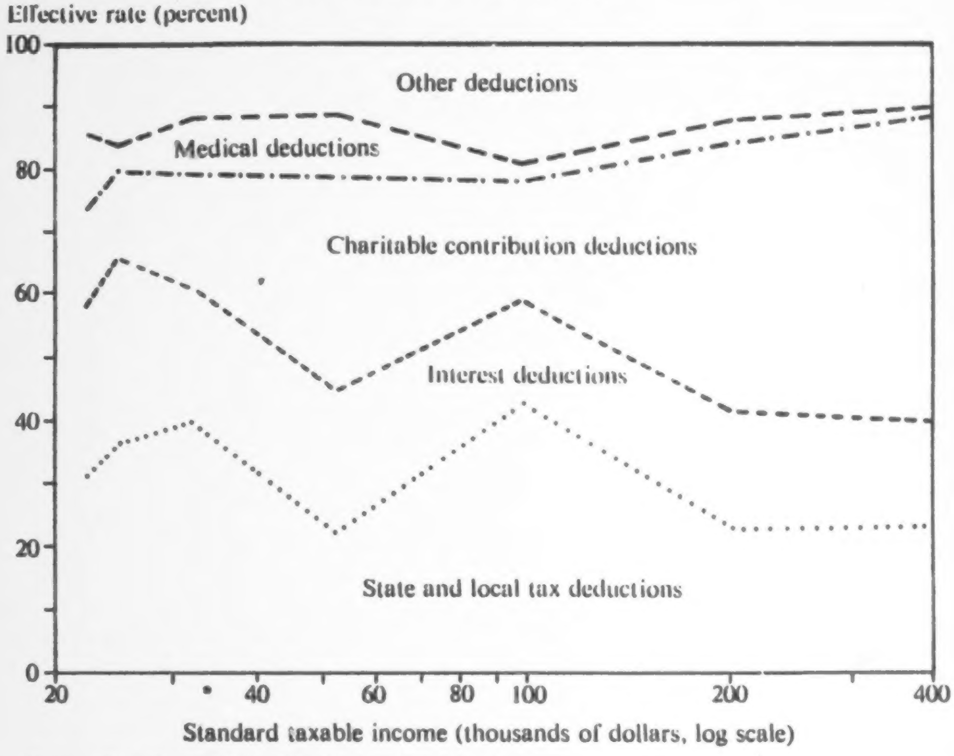
8. It is important to remember two factors in considering figures 7–9: (1) The figures show the percentage breakdown of different types of deductions in total deductions; in the lower effective tax rate groups, however, the absolute amount of deductions is higher in any given income class than in the higher tax groups; and (2) they show the total amount of each deduction claimed in each income class; certain types of deductions might be claimed in very large amounts but on few returns, leading to a small total.

Figure 8. Selected Itemized Deductions as a Percentage of Total Itemized Deductions: Taxes between 50 and 75 Percent of Average



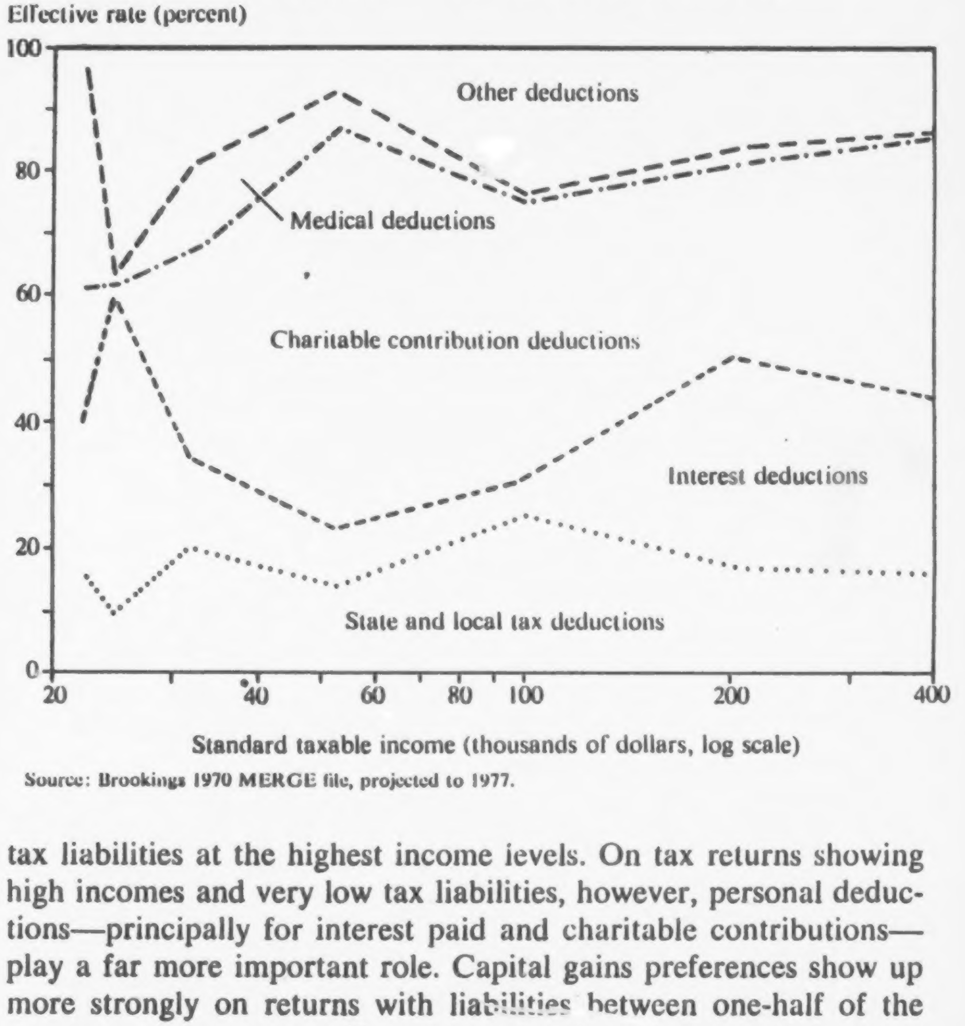
Source: Brookings 1970 MERGE file, projected to 1977.

than tax returns with higher effective rates. The reliance on interest and state and local tax deductions is lower. Above $200,000, however, the low tax rate returns show distinctly greater relative use of interest and charitable deductions and less of medical and state and local tax deductions; miscellaneous deductions are largely unchanged. Interest and charitable deductions are, of course, easily manipulable by the taxpayer to minimize tax liability.

Conclusions

These computations indicate that some qualification of earlier notions of the role of tax reduction devices may be in order. A view of the entire population indicates that preferences for realized long-term capital gains have an impact second only to personal deductions on

Figure 9. Selected Itemized Deductions as a Percentage of Total Itemized Deductions: Taxes Less than 25 Percent of Average but Greater than Zero



Source: Brookings 1970 MERGE file, projected to 1977.

tax liabilities at the highest income levels. On tax returns showing high incomes and very low tax liabilities, however, personal deductions—principally for interest paid and charitable contributions—play a far more important role. Capital gains preferences show up more strongly on returns with liabilities between one-half of the average and the average. For returns showing taxes around the average, the maximum tax on earned income reduces liabilities most. At lower income levels, personal deductions are the major tax reduction feature.

An examination of the itemized personal deductions used to reduce taxes shows again that the use of various devices changes with the degree of tax reduction. Returns showing low tax liability between about $20,000 and $200,000 of income make heavier relative use of deductions for medical expenses and charitable contributions than do returns with the same income and higher taxes.

The major implication of these findings is for tax policy with regard to leakages from the income tax base. If a major concern for policy is the total reduction of tax liabilities at upper income levels, then the capital gains preferences are virtually as important as personal deductions. If, on the other hand, the major concern is extreme cases of tax minimization, then most effort should be concentrated on personal deductions.

From: Henry J. Aaron and Joseph A. Pechman, Eds.
How Taxes Affect Economic Behavior. The
Brookings Institution, Washington, D.C. 1981.

JOSEPH J. MINARIK

Capital Gains

FEDERAL income tax treatment of capital gains is highly controversial. Long-standing equity and administrative issues continue to arouse heated debate: whether capital gains should be taxed at all; what preferential treatment, if any, gains should be given relative to ordinary income; to what extent net losses should be deducted from ordinary income; whether appreciated gifts and bequests should be taxed, or what basis they should carry to recipients; and many more. But perhaps because of the sluggish progress of the U.S. economy, the effect of capital gains taxation on economic growth and efficiency has claimed a great deal of attention. Economists and laymen argue about whether capital gains taxation reduces capital investment or distorts its allocation, thereby slowing the rate of growth of output and productivity. These questions were discussed during the congressional deliberations in 1978 that yielded significant reductions in the taxation of capital gains, and widely disseminated economic analyses of these issues may have had an important influence on the legislative outcome. The influence of capital gains taxation on the economy must be understood to evaluate the 1978 decision and to choose appropriate future policy; the purpose of this paper is to increase this understanding.

I am grateful to Gerald E. Auten, Barry Bosworth, Ralph B. Bristol, Jr., John A. Brittain, Harvey Galper, Robert W. Hartman, Jerry A. Hausman, Bruce K. MacLaury, Benjamin A. Okner, Arthur M. Okun, Joseph A. Pechman, George L. Perry, and Emil M. Sunley for their helpful suggestions; to Timothy A. Cohn, Katharine J. Newman, and Laurent R. Ross for research assistance; and to Arthur Morton and Nancy E. O'Hara, who supervised the computer programming. Support for this research was provided by the National Science Foundation; support for research using the IRS Seven-Year Panel of Taxpayers was provided by the U.S. Treasury Department.

Three Issues in Capital Gains Taxation

While numerous arguments have been raised for preferential treatment of long-term capital gains, this discussion will focus on three major issues: the bunching of long-term gains, the opportunities for timing the realization of gains and losses, and the lock-in effect of the tax on capital gains.

With progressive taxation of long-term gains upon realization, the included portion of a long-term gain is taxed at the taxpayer's highest marginal tax rate on ordinary income. If the gain is large relative to the taxpayer's typical ordinary income, it could fall into still higher marginal rate brackets and incur a tax liability significantly higher than if part of the gain were taxed each year during which the asset was held.[1] This bunching problem has been widely recognized in the general literature on capital gains taxation, though the data available have not permitted estimation of the frequency or the amount of overtaxation caused by bunching until quite recently.

Some experts have argued that bunching should be remedied through more exact methods than the present general exclusion of 60 percent of long-term gains. One possible solution would be to average capital gains and other income over the period the asset was held (or some maximum period longer than the five years available to any taxpayer under current law). Goode points out that income averaging would provide relief for a taxpayer whose taxable income (including the gain) was substantially larger than usual, but none if his income including capital gains was stable, however bunched an individual gain might be. Averaging would complicate the tax forms and require records from earlier years, but many transactions could be disqualified from averaging because they were too small relative to average total income for averaging to significantly affect the tax liability.[2]

An alternative to income averaging would be proration of capital gains over the number of years the asset was held or some maximum period. The portion representing appreciation in the current year would be taxed as usual; the remainder for previous years would be taxed at the same effective rate as that for the current year. The effect would be to moderate the rate progression applied to the gain; the share of the gain prorated to earlier years would not be allowed to reach into higher marginal rate brackets. David points out that proration, unlike averaging, would be based only on the current year's tax return and thus would require no record keeping beyond the asset's basis; also unlike averaging, proration would reduce the tax liability on a large gain held over several years even if taxable income, including gains, was stable. Goode argues that prorating more than a small number of gains would be unwieldy, and Wetzler contends that to adopt proration in addition to general income averaging would enormously complicate the tax code.[3]

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[1] For example, taxation in full of a $100,000 gain (held for two years) in 1978 would result in a liability of $24,180 for a single person claiming the standard deduction and having no other income. If the gain were split evenly between the two years, the total liability would be only $19,280. The problem is more serious the longer the holding period; it is nonexistent if the gain does not push the taxpayer into a higher marginal rate bracket.

[2] Richard Goode, *The Individual Income Tax*, rev. ed. (Brookings Institution, 1976), pp. 191–95.

The third way to solve the bunching problem is taxation of gains as they accrue rather than when they are realized. Accrual taxation would involve formidable problems, including the valuation of assets rarely sold, the inventorying of all assets with the filing of each return, and the payment of taxes on accrued gains that had not been realized in cash.[4]

Some experts contend that the bunching problem, while potentially serious under particular circumstances, is not worrisome in practice. They see bunching as the result of the taxpayer's privilege to defer the realization of the gain until a time of his choosing and thus defer taxation of the appreciation. Concessions such as averaging or proration would reduce the tax liability upon realization to approximately the sum of the liabilities that would have been due in each year if the gain had been taxed on accrual. This would give the taxpayer the advantage of the time value of money while the tax was deferred. Some experts argue that the deferral of taxes on capital appreciation is a significant benefit to recipients of capital gains and thus makes the need for other preferential treatment less urgent. Wetzler has proposed a deferral charge as compensation for the implicit interest-free loans from the federal government to holders of appreciating assets.[5]

[3] Martin David, *Alternative Approaches to Capital Gains Taxation* (Brookings Institution, 1968), pp. 166–80; Goode, *Individual Income Tax*, p. 192; James W. Wetzler, "Capital Gains and Losses," in Joseph A. Pechman, ed., *Comprehensive Income Taxation* (Brookings Institution, 1977), pp. 130–32.

[4] David, *Alternative Approaches to Capital Gains Taxation*, pp. 183–85.

[5] Wetzler, "Capital Gains and Losses," pp. 115–53. See also Roger Brinner and Alicia Munnell, "Taxation of Capital Gains: Inflation and Other Problems," Federal Reserve Bank of Boston, *New England Economic Review* (September–October 1974), pp. 3–21.

A further issue is the taxpayer's opportunity to time the realization of gains and losses. Consider the owner of a diversified portfolio of securities who relies on their appreciation to meet his cash needs. If his assets on the average increase in value but some decline, he can sell a balanced group of appreciating and depreciating assets with a total net gain of zero and pay no tax. The rest of his appreciating assets can be left to grow in value and under current law can be contributed to charity or bequeathed with no capital gains tax. Further, the heirs will not be liable for capital gains tax on the appreciation that occurred before they inherited the property. Some experts argue that the potential for deferring the tax and timing the realization renders further preferences somewhat redundant, but others believe that taxpayers with small portfolios cannot diversify sufficiently to take advantage of this. Available data have not permitted detailed analysis of the offsetting of gains and losses.[6] It is known that in 1962, of 4.3 million returns reporting net capital gains, 0.7 million realized some losses; and of 1.5 million reporting net losses, 0.7 million realized some gains.[7]

Some experts argue that taxation of gains locks investors in to assets that do not offer the best available yield. The lock-in effect takes two forms. First, the requirement that assets be held for a minimum length of time before preferential treatment is granted inhibits the sale of assets held for less than that period. Seltzer found that the five graduated holding periods in the law from 1934 to 1937 significantly reduced the turnover of capital assets.[8] Fredland, Gray, and Sunley demonstrated that realizations in 1962 were significantly reduced just before, and significantly increased just after, securities were held for six months.[9]

A lock-in effect also occurs when the tax that would be due upon the sale of an appreciated asset absorbs the profit from selling that asset and purchasing another with a higher pretax yield.[10] Brannon examined time series data and found evidence of reduced realizations as the result of capital gains taxation, but precise estimates were impossible because of data limitations.[11] Auten used pooled annual aggregate data by income class and identified a lock-in effect.[12] Feldstein, Slemrod, and Yitzhaki contend that actual realizations are highly sensitive to reductions in taxes applicable to capital gains, and that tax cuts would thus encourage enough additional realizations to increase total tax revenue. Using 1973 tax returns, they estimated a very high elasticity of realizations to the applicable marginal tax rate and computed on that basis that reducing the maximum tax rate on long-term capital gains from 45.5 percent to 25 percent would increase revenue.[13] Auten and Clotfelter, using a panel of tax returns for the 1967–73 period, found a smaller response to taxpayers' average tax rates over time. They also found a response to fluctuations in the tax rates (caused by variations in deductions and other income) that was greater than the response to average tax rates in some specifications.[14] Some experts counter that the lock-in effect is not so much the result of an insufficient preference for capital gains realizations as of forgiving income tax on capital gains held until death or given to charity and postponing tax on appreciation of assets given to other individuals. They claim that eliminating those preferences would be the best way to reduce the lock-in effect.[15]

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[6] David, *Alternative Approaches to Capital Gains Taxation*, pp. 73–81.

[7] U.S. Treasury Department, Internal Revenue Service, *Statistics of Income—1962, Supplemental Report, Sales of Capital Assets Reported on Individual Income Tax Returns* (Government Printing Office, 1966), p. 60, table 6, and p. 86, table 9.

[8] Lawrence H. Seltzer, *The Nature and Tax Treatment of Capital Gains and Losses* (National Bureau of Economic Research, 1951), pp. 167–72.

[9] J. Eric Fredland, John A. Gray, and Emil M. Sunley, Jr., "The Six Month Holding Period for Capital Gains: An Empirical Analysis of Its Effect on the Timing of Gains," *National Tax Journal*, vol. 21 (December 1968), pp. 467–78.

[10] Suppose that an investor paid $500 for stock that is now worth $1,000, and that the stock yields 10 percent with no prospect of further capital gain. If the effective tax rate on the gain is 20 percent, the investor could not profitably switch to a

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new security unless it yielded over 11.1 percent. The disincentive to reallocate funds from the security yielding 10 percent to any other yielding between 10 and 11.1 percent is the lock-in effect. Charles C. Holt and John P. Shelton, "The Lock-In Effect of the Capital Gains Tax," *National Tax Journal*, vol. 15 (December 1962), pp. 337–52; Beryl W. Sprinkel and B. Kenneth West, "Effects of Capital Gains Taxes on Investment Decisions," *Journal of Business*, vol. 35 (April 1962), pp. 122–34.

[11] Gerard M. Brannon, "The Lock-In Problem for Capital Gains: An Analysis of the 1970–71 Experience," in *The Effect of Tax Deductibility on the Level of Charitable Contributions and Variations on the Theme* (Washington, D.C.: Fund for Policy Research, 1974).

[12] Gerald E. Auten, "Empirical Evidence on Capital Gains Taxes and Realizations" (Treasury Department, Office of Tax Analysis, 1979).

[13] Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki, "The Effects of Taxation on the Selling of Corporate Stock and the Realization of Capital Gains," *Quarterly Journal of Economics*, vol. 94 (June 1980), pp. 777–91.

[14] Gerald E. Auten and Charles T. Clotfelter, "Permanent vs. Transitory Tax Effects and the Realization of Capital Gains" (Treasury Department, August 23, 1979).

[15] Martin J. Bailey, "Capital Gains and Income Taxation," in Arnold C. Harberger and Martin J. Bailey, eds., *The Taxation of Income from Capital* (Brookings Institution, 1969), pp. 11–49; David, *Alternative Approaches to Capital Gains Taxation*, pp. 145–64; Goode, *Individual Income Tax*, pp. 200–03, 209–10.

Bunching of Long-Term Gains

As mentioned earlier, the bunching of long-term gains in a single year under a progressive income tax can increase tax liabilities. On the other hand, taxation is deferred over the years in which the gains accrued, in effect constituting an interest-free loan of the tax liability on the accrued gain from the government to the asset holder. And taxpayers can choose the year in which they realize their gains to minimize their tax liability.

It is impossible to disentangle the relative effects of bunching and deferral with existing data. It is possible, however, to look at the bunching question and the timing of realization with the Internal Revenue Service Seven-Year Panel of Taxpayers, a random sample of identical filers' tax returns over the period 1967–73.[16]

The panel file shows only the total net gain or loss for any one year, and so it is impossible to gauge precisely the holding period over which any individual gain or loss item accrued. However, the file can show whether a net gain in one year is an isolated event or whether gains are realized in every year. It can also show whether the net gain in a particular year is taxed at a higher or lower marginal rate than is typical for the taxpayer over the duration of the panel. Because of the particular limitations and capabilities of the panel file, this analysis cannot compare the taxation of gains as they accrue, as opposed to lump sums when they are realized (that is, the type of bunching that is cited by advocates of proration). Rather, it will provide some indication of the frequency of realized gains that are large relative to average income over several prior and subsequent years (that is, the additional tax that would be prevented by a general capital gains averaging provision that corrected for losses as well as gains).

The bunching problem arises when a taxpayer realizes a long-term gain that is large relative to his average income.[17] Such a taxpayer would bear a far higher liability on that gain upon realization than he would under accrual taxation or a proration or averaging provision. In contrast, another taxpayer who is an active trader in capital assets may time his realizations along with his receipts of ordinary income and his itemized deductions, so that his income including capital gains is stable.[18] For such a taxpayer, mandatory averaging of capital gains over several years would increase rather than decrease total tax liabilities.

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[16] The file contains information on a uniform random sample of taxpayers; thus its coverage of upper income taxpayers with large amounts of capital gains is limited. The sample includes the returns of 21,382 taxpayers for at least one year each, but some of these did not file returns in all of the seven years. For this analysis the sample is limited to 3,430 taxpayers who filed returns in at least five of the seven years and realized capital gains or losses in at least one of the years in which they filed returns.

[17] The archetypical case is the sale of a business or partnership interest upon retirement

The relative frequency of realizations of "once in a lifetime" gains and of carefully timed recurrent gains should have an important influence on public policy. If highly bunched gains are common, policy should lean in the direction of protection from such extremes; but if many taxpayers already average by timing their gains, other income, and deductions appropriately, policies to ameliorate bunching are less urgent. This is especially true in light of the complexity of special provisions for taxpayers and tax authorities and the potential for abuse.[19]

To measure the extent of bunching, table 1 shows tax liabilities, by income class, for taxpayers in the panel file who realized long-term capital gains or losses in at least one year. Column 2 shows the average tax liability over the period with the 1973 tax law applied in each year and no income averaging permitted.[20] Column 3 shows the tax that would have been due under a complete income and deduction averaging system.[21] The difference between these columns is the additional tax that is due because of all fluctuations of income and deductions, including but not restricted to capital gains. For the entire population, this difference is about 9 percent of the tax liability without averaging. Column 4 is the total tax liability if capital gains, but no other income or deduction item, were averaged over the period.[22] For the entire population, averaging

[18] The same effect obtains if a taxpayer, to maintain his consumption, realizes gains when his other income is low.

[19] For some tax experts, the deferral of tax liability would be a compelling argument against concessions to recipients of long-term capital gains regardless of the impact of bunching.

[20] A single tax law is used because taxpayers who plan their realizations to minimize their tax liability are likely to attempt to stabilize their taxable income, and because changes in tax laws are difficult to anticipate. From that point of view, use of different tax laws over the period would mask the taxpayer's behavior. Income averaging is omitted for the same reason.

[21] That is, the tax due on the average amount of ordinary income and the average amounts of net long-term and net short-term gain, less the average amounts of deductions and personal exemptions.

[22] That is, the average tax that would be due if tax were calculated in each year on the actual amounts of ordinary income, deductions, and exemptions, and the average amounts of net long-term and net short-term gain or loss over the period. This tax system is applied as an analytical device rather than a policy proposal.

Table 1. Average Annual Tax over a Five-to-Seven-Year Period for Taxpayers Who Realized Capital Gains

Dollars unless otherwise specified

Adjusted gross income net of capital gains	*Number of returns*[a] *(1)*	*Tax with actual income and deductions per return per year*[b] (2)	*Tax with averaged income and deductions per return per year* (3)	*Tax with averaged capital gains and actual other income and deductions per return per year* (4)	*Percentage of tax saving through complete averaging achieved by averaging of capital gains only* (5)
Less than 0	16	133	45	1,302	−1,328.7
0–1,000	27	91	17	143	−70.6
1,000–2,000	85	80	28	67	25.1
2,000–3,000	128	155	95	135	34.1
3,000–4,000	158	250	182	225	36.6
4,000–5,000	163	377	277	344	32.3
5,000–10,000	949	805	699	758	44.1
10,000–15,000	921	1,570	1,426	1,481	61.9
15,000–20,000	459	2,656	2,428	2,496	70.0
20,000–25,000	220	3,701	3,403	3,538	54.7
25,000–50,000	227	7,487	6,917	7,248	41.9
50,000 and over	77	33,408	30,943	31,256	87.3
Total or average	3,430	2,521	2,298	2,390	58.6

Source: Internal Revenue Service Seven-Year Panel of Taxpayers.

a. Includes returns of taxpayers who submitted tax returns for at least five of the seven years and realized capital gains in at least one of those years.

b. Under provisions of the 1973 law.

capital gains over the seven years would reduce tax liabilities by about 5 percent. Thus capital gains bunching accounts for approximately 59 percent of the additional taxation caused by the absence of a complete averaging system. This fraction generally increases with income net of gains; in fact, averaging of only gains over the period would increase taxes for the two lowest income classes as a whole.

This result suggests that some taxpayers, even those at higher income levels, may time their gains to coincide with years in which their ordinary income is below average and their deductions are higher than normal. This question is explored further in tables 2, 3, and 4, which show the effect of averaging capital gains only over the entire sample period for taxpayers whose tax would be increased by such averaging—12.5 percent of the population. As mentioned earlier, this occurs when taxpayers with

Table 2. Tax Returns with Taxes Increased by the Averaging of Capital Gains, by Income Other Than Capital Gains

Income other than capital gains (dollars)	*Total number of returns*	*Returns with taxes increased by capital gains averaging*		*Percentage increase in tax caused by capital gains averaging*
		Number	*Percent*	
Less than 0	16	8	50.0	6,192.1
0–1,000	27	5	18.5	199.4
1,000–2,000	85	18	21.2	47.0
2,000–3,000	128	26	20.3	32.8
3,000–4,000	158	38	24.1	21.9
4,000–5,000	163	37	22.7	28.0
5,000–10,000	949	125	13.2	22.3
10,000–15,000	921	63	6.8	17.6
15,000–20,000	459	37	8.1	8.3
20,000–25,000	220	26	11.8	7.8
25,000–50,000	227	40	17.6	8.3
50,000 and over	77	7	9.1	6.0
Total or average	3,430	430	12.5	13.2

Source: Same as table 1.

Table 3. Tax Returns with Taxes Increased by the Averaging of Capital Gains, by Number of Years Gains Were Realized

Number of years gains were realized	*Total number of returns*	*Returns with taxes increased by capital gains averaging*		*Percentage increase in tax caused by capital gains averaging*
		Number	*Percent*	
1	1,283	108	8.4	14.0
2	569	68	12.0	10.3
3, 4, or 5[a]	808	98	12.1	6.5
4, 5, or 6[b]	306	67	21.9	11.8
5, 6, or 7[c]	464	89	19.2	21.2
Total or average	3,430	430	12.5	13.2

Source: Same as table 1.

a. Three years for taxpayers with five tax returns in the sample; three or four years for those with six returns; and three, four, or five years for those with seven returns.

b. Four years for taxpayers with five tax returns in the sample; five years for those with six returns; and six years for those with seven returns.

c. Five years for taxpayers with five tax returns in the sample; six years for those with six returns; and seven years for those with seven returns.

Table 4. Tax Returns with Taxes Increased by the Averaging of Capital Gains, by Amount of Capital Gains

Capital gains (dollars)	*Total number of returns*	*Returns with taxes increased by capital gains averaging*		*Percentage increase in tax caused by capital gains averaging*
		Number	*Percent*	
Less than 0	751	64	8.5	8.1
0–1,000	1,940	206	10.6	10.2
1,000–2,000	302	63	20.9	10.8
2,000–3,000	137	32	23.4	12.2
3,000–5,000	137	27	19.7	13.0
5,000–10,000	88	21	23.9	9.7
10,000–25,000	46	10	21.7	22.2
25,000 and over	29	7	24.1	32.8
Total or average	3,430	430	12.5	13.2

Source: Same as table 1.

fluctuating ordinary income realize capital gains in years of low ordinary income and thus stabilize their total income. Further, frequent traders are likely to time their realizations to coincide with years in which their tax rates are low—one in five taxpayers with gains in all years or all but one year would have their taxes increased by mandatory averaging of gains, as against one in eight for the population as a whole. The frequency of such tax increases is a U-shaped function of income other than gains, but an increasing function of total gains. Tax increases caused by the averaging of gains equal approximately 13 percent of liability based on actual gains.

The tendency to time realizations is evident in the data themselves. With the use of yearly percentage deviations (*%DEV*) of adjusted gross income (net of all capital gains), itemized deductions (exclusive of state income and sales taxes), and net capital gains from the mean values for individual taxpayers for the duration of the panel, the following regression equation was obtained from the panel data (*t*-statistics are given in parentheses):

$$\%DEVGAIN = \underset{}{1.3231} - \underset{(3.067)}{0.0601}\ \%DEVAGI + \underset{(13.189)}{0.4254}\ \%DEVDED.$$

$$R^2 = 0.0075;\ \text{standard error} = 200.321$$

The equation indicates that, if a taxpayer's adjusted gross income (*AGI*) in any one year is 1 percent higher than his mean adjusted gross income over the seven years of the panel, his net capital gains (*GAIN*) will be about 0.06 percent lower than his mean value. Further, if his itemized deductions (*DED*) are 1 percent higher than his mean deductions over the seven years, his net capital gains will be about 0.4 percent greater than his mean value. Both coefficients are consistent with the hypothesis that taxpayers tend to realize gains when their tax rates are temporarily reduced, although the deductions effect seems to be much more pronounced than the income effect.

These results suggest that many taxpayers do experience bunching of capital gains, as conventionally assumed, and incur higher tax liabilities as a result. The income averaging system now in the law reduces such excess liabilities. On the other hand, others time their gains and losses when their deductions are high and their other income is low in order to reduce their tax liabilities; those who realize the greatest gains and who realize them most frequently are the most likely to time their realizations. This benefit of the realization principle for capital gains recipients is often overlooked.

Timing of Capital Gains and Losses

Because the data used in the preceding analysis include only net short-term and net long-term capital gains or losses, it was not possible to measure the extent to which individual gain or loss transactions were used to offset each other. The 1973 Internal Revenue Service Sales of Capital Assets File provides detail on individual capital transactions and therefore can be used to analyze the timing of capital gains and losses during a single year.[23]

Table 5 summarizes the information on realized capital gains and losses in the 1973 file. Column 3 shows that 24 percent of all returns with net gain reported at least some losses, and that the frequency of realizing offsetting gains and losses increases sharply as income increases. The ratio

[23] The Sales of Capital Assets File contains information on the approximately 50,000 tax returns from the IRS Individual Tax Model File (which contains a total of approximately 100,000 tax returns) that include capital transactions. Each transaction is detailed with the type of asset, the dates of acquisition and sale of the asset, and the cost basis and purchase price. The Sales of Capital Assets File shares the stratified sample design of the Individual Tax Model File, with 100 percent sampling of tax returns with adjusted gross income above $200,000. Thus the Capital Assets File includes a rich sample of tax returns with large and numerous capital asset transactions, but has also been stratified accurately to replicate the entire population.

Table 5. Capital Gains and Losses on Federal Income Tax Returns, 1973

Adjusted gross income net of capital gains (dollars)	*Number of returns with net gain* (1)	*Number of net gain returns with some losses* (2)	*Percent of net gain returns with some losses* (3)	*Gross gain divided by net gain* (4)	*Number of returns with net loss* (5)	*Number of net loss returns with some gains* (6)	*Percent of net loss returns with some gains* (7)	*Gross loss divided by net loss* (8)
None	121,979	21,404	17.6	1.3	25,449	5,932	23.3	1.9
0–2,500	308,969	58,866	19.1	1.5	101,570	53,021	52.2	1.4
2,500–5,000	299,363	56,719	19.0	1.6	119,672	19,120	16.0	1.4
5,000–7,500	284,160	34,464	12.1	1.5	124,637	23,742	19.1	1.5
7,500–10,000	311,023	74,756	24.0	1.4	125,035	39,535	31.6	3.5
10,000–15,000	536,069	95,290	17.8	1.6	283,754	85,199	30.0	1.5
15,000–20,000	423,784	100,355	23.7	1.6	343,242	113,548	33.1	1.8
20,000–25,000	269,874	78,082	28.9	1.5	254,347	83,984	33.0	1.4
25,000–30,000	194,498	59,809	30.8	1.5	159,861	80,267	50.2	1.6
30,000–50,000	312,968	122,800	39.2	1.7	265,850	104,771	39.4	1.9
50,000–100,000	142,776	66,690	46.7	1.7	116,732	60,895	52.2	2.0
100,000–200,000	33,481	17,714	52.9	1.5	23,655	14,904	63.0	2.1
200,000–500,000	6,898	4,059	58.8	1.4	4,063	2,836	69.8	1.9
500,000–1,000,000	721	436	60.5	1.3	382	301	78.8	2.2
1,000,000 and over	228	148	64.9	1.3	144	117	81.3	1.9
Total or average	3,246,791	791,592	24.4	1.5	1,948,393	688,172	35.3	1.8

Source: Internal Revenue Service Sales of Capital Assets File.

Table 6. Ratio of Stock Sales to Dividends for Returns with Net Stock Gains

Class of net stock gain (dollars)	*Number of returns*	*Stock sales divided by dividends*
0–2,500	718,576	2.5
2,500–5,000	163,942	4.9
5,000–7,500	76,615	4.7
7,500–10,000	32,224	7.9
10,000–15,000	57,787	4.1
15,000–20,000	19,327	4.5
20,000–25,000	19,779	8.3
25,000–30,000	11,063	6.0
30,000–50,000	21,123	7.1
50,000–100,000	15,721	7.8
100,000–200,000	8,387	17.3
200,000–500,000	3,658	13.4
500,000–1,000,000	1,066	12.9
1,000,000 and over	603	19.5
Total or average	1,149,871	6.6

Source: Same as table 5.

of gross gain to net gain decreases slightly with income. Columns 7 and 8 show similar results for net loss returns, but with the ratio of gross loss to net loss increasing with income.

A further aspect of the timing issue is the degree to which shareholders at various net gain or loss levels turn over their portfolios in any given year. Table 6 shows that the ratio of stock sales to dividends rises sharply as net stock gains increase. Moreover, returns with large net stock gains reported ratios of stock sales to dividends that are high relative to the ratio of the value of all stock outstanding to total dividend payments.[24] Thus for many investors with large portfolios, the potential for realization of larger amounts of capital gains in response to reduced tax rates on gains is limited.[25]

[24] The ratio of stock sales to dividends for returns with net stock gains of $1,000,000 or more was 19.5. Based on the average 1973 dividend yield of 0.0306 (*Economic Report of the President, 1979,* p. 285, table B-88), the ratio of total portfolio value to dividends averages 32.7.

[25] Simulations of the tax implications of unlocking accrued gains often rely on a proportional increase in realized gains based on changes in effective tax rates (such as Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation"). On this basis, much of the simulated increase in realized gains (in absolute terms) comes from tax returns that already have large amounts of realized gains. Table 6 suggests that many of those returns may have limited additional gains to realize.

Table 7. Relationship of Stock and Nonstock Gains and Losses, Returns with Net Stock Gain, 1973

		Returns with nonstock net gain		*Returns with nonstock net loss*	
Adjusted gross income net of capital gains (dollars)	*Number of returns*	*Percent of all returns*	*Nonstock gain divided by stock gain*	*Percent of all returns*	*Nonstock loss divided by stock gain*
None	18,061	37.4	1.5	17.7	−0.2
0–2,500	89,444	3.3	0.8	21.4	−0.5
2,500–5,000	62,618	21.2	7.1	3.5	−0.8
5,000–7,500	77,616	9.9	1.8	17.8	−0.2
7,500–10,000	104,890	8.7	0.8	15.4	−0.4
10,000–15,000	167,090	9.1	0.7	6.6	−0.2
15,000–20,000	156,916	13.0	1.2	12.7	−0.5
20,000–25,000	121,529	20.1	0.8	11.1	−0.7
25,000–30,000	92,487	18.2	0.8	17.4	−0.7
30,000–50,000	160,678	20.4	0.7	16.1	−0.3
50,000–100,000	74,601	26.2	0.6	16.8	−0.4
100,000–200,000	19,232	32.4	0.6	19.7	−0.3
200,000–500,000	4,150	38.9	0.6	23.8	−0.4
500,000–1,000,000	432	43.8	0.4	26.1	−0.5
1,000,000 and over	127	49.6	1.1	32.4	−0.1
Total or average	1,149,871	15.4	1.0	13.8	−0.4

Source: Same as table 5.

A final consideration for any analysis focused on stock gains is the degree to which gains or losses on other types of assets might confuse the analysis. Tables 7 and 8 show that 30 percent of all tax returns with gains or losses on corporate stock also have gains or losses on other assets. The degree to which taxpayers use losses on stock, which is a relatively liquid asset, to offset gains on nonstock assets, which may be less liquid, is striking. Nonstock losses are particularly large relative to stock gains in the $1,000,000 and over ordinary-income class, where 59 percent of all returns with net losses on stock have net gains on other assets, and on average there is more than $1 of stock loss for every $2 of nonstock gain. The prevalence of such offsetting gains and losses suggests that the relationship between marginal tax rates and gains on corporate stock cannot be analyzed without regard to other factors.[26]

Two conclusions may be drawn from this analysis. First, estimates of

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[26] For example, an upper income taxpayer with large nonstock gains may show a high first-dollar tax rate on stock gains owing to his normal tax rate and the appli-

Table 8. Relationship of Stock and Nonstock Gains and Losses, Returns with Net Stock Loss, 1973

Adjusted gross income net of capital gains (dollars)	*Number of returns*	*Returns with nonstock net gain*		*Returns with nonstock net loss*	
		Percent of all returns	*Nonstock gain divided by stock loss*	*Percent of all returns*	*Nonstock loss divided by stock loss*
None	12,934	49.3	−4.9	24.1	1.4
0–2,500	59,326	14.3	−7.3	0.9	0.3
2,500–5,000	64,287	17.1	−1.9	2.3	6.8
5,000–7,500	68,609	18.1	−3.0	16.1	2.3
7,500–10,000	65,447	7.7	−2.9	5.8	0.9
10,000–15,000	190,480	16.1	−1.8	7.9	1.7
15,000–20,000	254,904	16.1	−2.6	16.8	0.5
20,000–25,000	196,318	18.9	−2.2	8.5	0.4
25,000–30,000	136,442	26.1	−1.2	10.8	0.2
30,000–50,000	227,225	19.4	−2.0	11.9	1.3
50,000–100,000	102,470	28.6	−2.1	14.2	0.6
100,000–200,000	22,050	38.1	−2.4	13.9	0.6
200,000–500,000	3,858	47.6	−2.9	16.6	1.0
500,000–1,000,000	401	50.6	−4.9	21.9	0.6
1,000,000 and over	148	58.8	−1.9	25.0	0.2
Total or average	1,404,899	19.3	−2.4	11.0	0.7

Source: Same as table 5.

the relationship of tax rates and capital gains realizations must take account of offsetting gain and loss transactions, lest serious errors be made. Second, the timing option often permits tax-free reallocations of investments in corporate stock and other capital assets. For those with holdings large enough to permit diversification, the timing option is particularly significant.

Locking In Caused by Marginal Tax Rates

A final question is the effect of the level of capital gains tax rates on asset holders' decisions to realize. As mentioned earlier, taxes on capital

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cation of the minimum tax and maximum tax offset. If that taxpayer realizes large stock losses to offset those nonstock gains, a regression will show an overlarge negative coefficient on the basis of this nonmarginal strategy. In the opposite case, large nonstock losses (or capital loss carry-overs) may produce a zero tax rate and large positive stock gains in circumstances with little relevance for estimating the elasticity of responses to marginal changes of nonzero tax rates.

gains do make realization and reinvestment less profitable, but because the incentive effects of the tax law are based largely on expectations of the relative future performance of alternative investments, the magnitude of the tax effects in practice is uncertain. Empirical analysis has been limited by a lack of appropriate data, but the 1973 Sales of Capital Assets File permits such analysis.

This analysis is restricted to realizations of gains and losses on corporate stock because stock investments are highly liquid and are typically made for the purpose of capital gain. The analysis here follows the general methodology of Feldstein, Slemrod, and Yitzhaki, but with some refinements.[27]

Even though the capital assets file is by far the richest source of data available on realizations of capital gains, it cannot support analysis that uses a sophisticated structural model of taxpayer behavior.[28] In particular, the lack of information on investors' holdings and purchases of stock, in detail comparable to that on sales, prevents the application of a model based firmly in theory.

Instead, I begin with a reasonable reduced-form model:

> Realized long-term corporate stock gains = *F* (dividends, other income, gains on other assets, carry-over and losses on other assets, itemized deductions, business losses, and the marginal tax rate).

Realization of gains is probably a function of the size of the taxpayer's portfolio. Tax returns provide no direct measure of portfolio size, but the amount of dividends can be used as a proxy indicator.[29] Those with large holdings may be active traders and may realize large fractions of their accrued gains each year. On the other hand, those with small portfolios may realize all their gains in a single sale. Thus the qualitative effect of portfolio size on the amount of gains realized in a given year is uncertain. After finding that the tax rate does not have a statistically significant effect on capital gains realizations for the entire population, Feldstein, Slemrod, and Yitzhaki removed from their sample all cases with dividends of less than $3,000.[30]

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[27] "Effects of Taxation."

[28] The theoretical underpinning of the lock-in effect is the work of Holt and Shelton, "Lock-In Effect," and Sprinkel and West, "Effects of Capital Gains Taxes." The short- and long-run effects of the capital gains tax can be seen from the example presented earlier. An investor paid $500 for stock that has now stabilized in value at $1,000 and that yields 10 percent of current value. With an effective capital gains tax rate of 20 percent, the investor can only be made better off by switching to a stock that yields 11.1 percent or more. If the capital gains tax rate is reduced to 15 percent, stock yielding 10.8 percent or better will increase the investor's income stream. At the time of the tax cut, the investor who held his stock under the higher tax rate would immediately switch if he knew of any alternative asset yielding between 10.8 and 11.1 percent. That is the short-run effect.

In the longer run, a lower capital gains tax rate would reduce the yield differential necessary to induce any investor to switch to an asset of higher yield. If yields fluctuate over time, the lower the capital gains tax rate is, the greater the likelihood in any period that some alternative asset will reach a yield high enough to induce the investor to switch will be. That is the long-run effect.

The theory is complicated in application by investor uncertainty, as well as by the commingling of yield and capital gains objectives.

The equations in this paper likewise show no apparent relationship between tax rates and realizations for the entire population, so tax returns with dividends below $3,000 were removed from the analysis. However, some effort was devoted to finding the degree to which locking in caused by tax rates does appear for various portfolio sizes. Dividends were entered into the equations in a quadratic form to allow for nonlinearities and also as an interaction term with the tax rate.

Income from sources other than stock sales might also influence realization behavior. A small income might induce stock sales to maintain current consumption. A high income would certainly obviate the need for stock sales to maintain consumption, but it might also be associated with financial sophistication and frequent trading. Adjusted gross income net of stock gains is entered into the equations in a quadratic form to allow for nonlinearities. An interaction term with the tax rate is also used. Inclusion of actual stock gains in the income variable would result in multicollinearity with any tax rate on gains. Inclusion of an average amount of stock gains in income would impart a negative bias to the coefficient (because such a variable would underestimate adjusted gross income for returns with high gains and overestimate income for those with low gains).

In general, older taxpayers would be expected to be more reluctant to realize gains, because appreciation on assets transferred at death would never be subject to income tax. At the same time, older taxpayers, with their reduced labor income, are more likely to need the proceeds of asset sales to maintain accustomed levels of consumption. The incomes of the aged who do not realize gains may be so low that they need not file tax returns, thus making realizations more frequent among the filing population. Further, large stock gains relative to dividends may reflect realizations of capital gains on shares held for long periods of time, which the elderly are most likely to have in their portfolios. Tax returns permit the identification of taxpayers (single or either spouse filing a joint return) over sixty-five years old; a dummy variable is used in the equations to differentiate such returns.

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[29] Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation," p. 781, note that upper income (and thus higher tax rate) shareholders may hold more low-yield growth stocks, citing Marshall E. Blume, Jean Crockett, and Irwin Friend, "Stockownership in the United States: Characteristics and Trends," *Survey of Current Business* (November 1974), p. 18. Such regressions therefore tend to understate the effect of tax rates on realizations.

[30] At the 1973 average dividend payout rate of 3.06 percent (*Economic Report of the President, 1979*, table B-89), this represents a portfolio of almost $100,000. Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation," p. 782, state that tax returns with at least $3,000 of dividends received 79 percent of all dividends reported.

A distinction must be drawn between the effects of temporary and permanent tax rate reduction. A taxpayer might find the capital gains tax rate extraordinarily low in any given year for several reasons. He might choose to borrow heavily in order to invest for gains, and thus have large deductions for investment interest and a taxable income (and thus marginal tax rate) lower than normal. He might choose to make substantial gifts to charity, which are deductible and reduce his taxable income. He may have extraordinary business losses that reduce his gross income below its normal level. Finally, he may have capital losses on assets other than stock (or accumulated loss carry-over) that would offset equal amounts of stock gain.[31] A stockholder with a portfolio of appreciated stock in any of these circumstances might choose to realize some or all of his gains in order to take advantage of his temporarily low marginal tax rate. If tax rates were reduced permanently by law, the same taxpayer might choose to realize those gains in the first year, thus reducing his stock of accrued gains for succeeding years; or he might not react immediately because he could realize those gains in later years at the same tax rates. In any event, the influence of transitory factors must not be confused with the continuous effects of statutory tax rates.

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[31] Alternatively, a taxpayer may realize large capital losses on stock to offset large capital gains on other assets. The IRS Sales of Capital Assets File contains a number of high-income returns with such offsetting gains and losses. Inclusion of these cases in the regression analysis without some control for the offsetting gains and losses overstates the effect of marginal tax rates on realizations. Because those returns show large positive gains before stock losses are considered, their marginal tax rate on gains appears high; the high tax rate is then associated, not with zero gains, but with negative gains, which overstates the absolute value of the negative coefficient. Controlling for the offsetting transactions through an independent variable (as described in the text) has a significant effect on estimated realizations.

To eliminate the transitory effects, several independent variables are added to the regression equations.[32] The sum of capital loss carry-over and gains or losses on assets other than stock (and short-term gains or losses on stock) is included. The value is entered as either a positive or a negative variable, according to its sign, to allow for different taxpayer responses to nonstock gains as opposed to nonstock losses and carry-over. The expected sign is negative, with carry-over and losses on assets other than stock expected to attract offsetting stock gains, and gains on other assets expected to attract stock losses. The amount of business losses is also included, with an expected negative sign. Finally, the amounts of deductions for cash and noncash charitable contributions and interest paid (other than on home mortgages) are included.[33]

The tax rate variable can be defined in several different ways. The effective tax rate on the last dollar of capital gains is the relevant cost for the investor's decision to realize additional gains, though not the cost of realizing the actual gains, and it is strongly collinear with the amount of gains realized. The first-dollar tax rate avoids this multicollinearity, but it is at best not representative of the tax that may be due on a more reasonable amount of gains, and at worst can be very misleading if there are small amounts of carry-over or other losses.[34] Any approximation based on a combination of these two shares their defects. The variable used here is the effective tax rate on a predicted amount of stock gain, which is based on the amounts of dividends and adjusted gross income net of stock gains.[35] This formulation has the virtues of avoiding both the simultaneity of capital gains realizations with the tax rate (because the predicted amount of gain on which the tax rate is calculated is not directly related to the taxpayer's actual gains) and the distortion of the tax rate caused by small amounts of losses or carry-over (because the predicted gain is large enough to swamp typical amounts of losses or carry-over).[36]

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[32] Without these independent variables the equations estimate the short-run effect of the tax on realizations, as described in note 28, above. With the independent variables, the result is closer to the long-run effect.

[33] These deductions represent only 24.9 percent of total itemized deductions for 1973, so there is no danger that the deductions variable will generate an approximate identity between adjusted gross income and taxable income. Internal Revenue Service, *Statistics of Income—1973, Individual Income Tax Returns* (GPO, 1976), pp. 48–49, table 2.2, p. 53, table 2.5, and pp. 56–57, table 2.7.

All of the variables used to control for transitory influences may in some sense be endogenous to the realization decision. For example, while an investor may be encouraged to realize a gain by a large charitable contribution he had made, he might also make such a contribution to reduce the tax on an earlier or subsequent realization. The exact nature of this simultaneous relationship is difficult to model, and because the effect of the independent variables on the estimated elasticities is relatively small, no attempt is made to generalize the model to encompass the simultaneity.

[34] For example, the tax on the first $100 of stock gain for a return with $1,100 of short-term loss carry-over is zero; if the carry-over was only $1,000, however, the gain would be taxed at the ordinary rate, which could be as high as 70 percent. If the typical stock gain for such tax returns was substantially larger than $100, neither of those figures would be indicative of the real tax price of realization.

The equations are estimated with ordinary least squares. All the variables on both sides of the equation are divided by dividends, as a correc-

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[35] The predicted amount of stock gain is the average within fifty-six subpopulations cross-classified by dividends and adjusted gross income.

[36] This approach differs from that of Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation," pp. 780–81. They used an instrumental variable technique predicting the last-dollar tax rate on actual gains, using the last-dollar tax rate on predicted gains and the first-dollar tax rate as instruments. This formulation yields a weighted average of the two tax rates and is unsatisfactory (as was argued above) both because the variable predicted in the first stage is not appropriate for the second-stage equation and because the tax rates used as instruments are subject to distortion from carry-over and losses on other assets. To demonstrate the basic similarity of these two approaches but to isolate the difference, the Feldstein, Slemrod, and Yitzhaki equation was replicated but with the new tax rate formulation. Feldstein, Slemrod, and Yitzhaki report the following result from an unweighted regression (t-statistics are given in parentheses):

$$\begin{array}{rl} GAINS/DIVIDENDS = 35.0 & + \underset{(0.50)}{0.18\,AGE65} - \underset{(10.34)}{1.23 \log (DIVIDENDS)} \\ & - \underset{(4.31)}{0.50 \log (AGI)} - \underset{(13.11)}{0.50\,TAX}, \end{array}$$

where *GAINS* is long-term gains on stock, *AGE65* is a dummy variable taking the value 1 if a personal exemption for sixty-five or over is claimed, *AGI* is adjusted gross income net of stock gains plus predicted stock gains in *AGI* (based on net *AGI* and dividends), and *TAX* is the instrumental variable (no first-stage equation is reported). When the tax rate is changed to the formulation to be used in this paper, the result is:

$$\begin{array}{rl} GAINS/DIVIDENDS = 30.17 & + \underset{(1.07)}{0.36\,AGE65} - \underset{(10.85)}{1.22 \log (DIVIDENDS)} \\ & - \underset{(10.74)}{0.80 \log (AGI)} - \underset{(17.02)}{0.25\,TAX}. \end{array}$$

The Feldstein, Slemrod, and Yitzhaki result implies an elasticity of realizations with respect to the tax rate of −23.8; the result with the new tax rate is −11.8. Though numerically different, both estimated elasticities might fairly be described as astronomical. These results are presented only to compare the Feldstein, Slemrod, and Yitzhaki and the new tax rate formulations; it will be shown below that all the coefficients in both these equations are greatly biased.

tion for heteroscedasticity.[37] The results of the equation are shown in table 9. Equation 1, for returns with dividends of at least $3,000 and omitting the independent variables for the transitory effects, shows that long-term stock gains over the relevant range is a decreasing function of income from sources other than stock and an increasing function of dividends, all else being equal.[38] The dummy variable for elderly taxpayers shows a negative and statistically significant coefficient, indicating that the inhibiting effect of potential tax avoidance through step-up of basis overrides the greater financial need of some of the elderly and leads to lower stock sales in that group.

The tax rate and interaction coefficients in equation 1 yield an elasticity estimate of −0.44 at the means of all the variables, indicating that a capital gains tax rate reduction would result in a loss of tax revenue. However, such an inference must be considered tentative in light of the a priori arguments expressed earlier for either a rising or a falling elasticity with respect to portfolio size. Equation 1 allows an examination of this question because its interaction terms generalize the relationship between the elasticity and portfolio size. The next to last line in table 9 shows that the estimated elasticities are −0.21 in the $3,000–$10,000 dividend class, −0.31 in the $10,000–$20,000 class, −0.42 in the $20,000–$50,000 class, and −1.49 for recipients of dividends of $50,000 and over. Thus only for portfolios of over approximately $1,500,000 of corporate stock

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[37] The same equation without the normalization of all variables by dividends (for returns with at least $3,000 of dividends) provides approximately the same elasticity estimate at the mean dividend, income, and tax rate values as the normalized equation, but elasticity estimates at typical variable values for portfolio sizes larger than average rise until, for returns with more than $50,000 in dividends, they are counterintuitively positive.

[38] Feldstein, Slemrod, and Yitzhaki ("Effects of Taxation") found a strongly significant negative relationship to dividends. The differences between their findings and mine apparently result because they used an unweighted regression and I computed with the sample weights. Weighting of the regressions is required because the sample is selected according to stratified sampling rates based on adjusted gross income, which includes all of short-term and one-half of long-term capital gains. Therefore, all else being equal, returns with larger capital gains are more likely to be in the sample than returns with smaller gains. Under these circumstances coefficients derived through ordinary least squares will be biased. Weighted least squares produces consistent estimates, though the accuracy of the estimates of the standard errors depends on the sample size, which in this case is extremely large. See Jerry A. Hausman and David A. Wise, "Stratification on Endogenous Variables and Estimation: The Gary Income Maintenance Experiment," in Charles Manski and Daniel McFadden, eds., *Econometric Analysis of Discrete Data* (MIT Press, forthcoming).

Table 9. Regression Results on Realizations of Long-Term Stock Gains, 1973

Independent variable[a] *or summary statistic*	*Dividend class and equation number*					
	$3,000 and over *(1)*	*$3,000 and over* *(2)*	*$3,000–$10,000* *(3)*	*$10.000–$20,000* *(4)*	*$20,000–$50,000* *(5)*	*$50,000 and over* *(6)*
Constant	2,925 (4.259)	1,946 (2.876)	3,565 (1.219)	−27,390 (1.420)	−50,460 (3.435)	40,900 (3.965)
Age dummy	−1,231 (3.686)	−731.6 (2.217)	−649.4 (1.138)	−1,216 (0.937)	−4,397 (2.914)	−4,180 (1.280)
Dividends	0.5121 (4.157)	0.3807 (3.123)	−0.08057 (0.072)	4.276 (1.495)	3.405 (3.571)	0.2652 (1.941)
Dividends^2	0.3865 (10^{-6}) (0.550)	−0.4311 (10^{-7}) (0.063)	0.2733 (10^{-4}) (0.272)	−0.1213 (10^{-3}) (1.199)	−0.2955 (10^{-4}) (1.968)	−0.1348 (10^{-6}) (1.253)
Adjusted gross income	0.008712 (1.184)	0.002423 (0.306)	0.007469 (0.535)	−0.1208 (5.402)	−0.1355 (6.325)	−0.2439 (9.884)
Adjusted gross income^2	0.8561 (10^{-9}) (1.470)	−0.3746 (10^{-8}) (4.959)	−0.5716 (10^{-8}) (4.057)	0.1794 (10^{-9}) (0.057)	−0.2385 (10^{-8}) (0.351)	0.5046 (10^{-8}) (7.153)
Gains on other assets	. . . . . .	−0.1093 (15.650)	−0.1260 (9.879)	−0.05393 (3.146)	−0.05382 (3.876)	−0.07818 (5.456)
Carry-over plus losses on other assets	. . .	−0.001871 (0.105)	0.03498 (1.076)	−0.1700 (4.138)	−0.3598 (12.356)	−0.0369 (2.183)
Interest deductions	. . .	0.2473 (5.750)	0.2224 (2.861)	0.4987 (4.703)	0.0986 (1.196)	0.2227 (3.201)
Cash charitable contributions deductions	. . .	1.010 (12.940)	0.9633 (6.658)	1.170 (7.497)	0.9415 (6.941)	0.9552 (7.926)

Noncash charitable contributions deductions	. . .	1.939	1.859	2.363	2.351	2.808
		(21.698)	(11.106)	(12.970)	(15.394)	(31.472)
Business losses	. . .	−0.1257	−0.1526	−0.009194	−0.1936	−0.2222
		(11.371)	(7.497)	(0.346)	(7.982)	(9.099)
Marginal tax rate	−524.8	−334.4	−445.4	. . .[b]	1,119	−1,109
	(8.284)	(5.281)	(4.380)		(3.312)	(2.693)
Marginal tax rate^2	28.63	13.20	16.15	. . .[b]	. . .[b]	. . .[b]
	(12.664)	(5.521)	(3.757)			
Marginal tax rate times dividends	−0.01569	−0.01321	. . .[b]	−0.02378	−0.06334	−0.01187
	(2.352)	(2.007)		(3.196)	(5.051)	(2.267)
Marginal tax rate times AGI	−0.004812	−0.001658	−0.002059	0.004174	0.003683	0.00492
	(14.452)	(3.943)	(2.729)	(4.021)	(4.013)	(5.793)
Corrected $\bar{R}^2$	0.0170	0.0560	0.0586	0.0758	0.1313	0.1453
F	58.47	119.29	42.54	30.98	62.66	123.39
(Degrees of freedom)	(9; 29,879)	(15; 29,873)	(14; 9,323)	(13; 4,741)	(14; 5,698)	(14; 10,068)
Corrected standard error of estimate	5.065	4.963	5.624	3.384	2.040	2.109
Elasticity from own equation	−0.44	−0.79	−0.76	−0.79	−1.08	−1.27
Elasticity from equation 1	−0.44	−0.44	−0.21	−0.31	−0.42	−1.49
Elasticity from equation 2	−0.79	−0.79	−0.65	−0.86	−0.70	−1.22

Source: Internal Revenue Service Sales of Capital Assets File. Standard errors of the variables are in parentheses.

a. The dependent variable is long-term stock gains. All variables are divided by dividends.

b. Coefficient failed test of statistical significance; variable was therefore omitted from equation for computation of elasticity.

would capital gains tax cuts generate sufficient additional realizations to result in an increase in revenue.

Equation 2 uses the same general specification on the same population but adds the variables used to control for fluctuations in tax rates. The relationship of gains to adjusted gross income becomes significant and negative rather than insignificant and positive. The variable for gains on other assets shows a large and significant negative coefficient, as expected. This coefficient is consistent with the data in tables 7 and 8, which demonstrated that many taxpayers seek to match their realized gains on other assets with stock losses to minimize their tax liabilities. The variable for nonstock losses (including carry-over) has a smaller coefficient and is statistically insignificant. The business loss variable is also significant with the expected sign. The variables for itemized deduction items all show the expected sign and statistical significance. The elasticity estimate for the entire population is −0.79, which is higher than that for the equation without the additional independent variables. The puzzle of this discrepancy is somewhat reduced when the elasticities for various portfolio sizes are computed. As shown in the bottom line of table 9, equation 2 yields elasticities of −0.65, −0.86, −0.70, and −1.22 for the dividend classes in ascending order. It is reasonable that the independent variables for transitory influences reduce the measured tax effect most for taxpayers with large portfolios, who would tend to be more diversified and thus to have some shares that could profitably be switched with a temporary reduction in their effective tax rates. Taxpayers with smaller portfolios would be less likely to respond to fluctuations in tax rates because their portfolios would probably be less diversified, and measurement of the incremental effect of the fluctuations might therefore be more tentative.

To confirm the elasticities estimated from equation 2, the same equation was run on subsamples corresponding to the dividend classes specified above. The elasticity estimates were quite similar at −0.76, −0.79, −1.08, and −1.27. These results suggest again that taxpayers with stock portfolios larger than $1,500,000 would increase their realizations of gains by a greater percentage than a cut in the capital gains tax, and further indicate that those in the $600,000–$1,500,000 range would increase realizations very slightly more than tax rates were reduced. The range of elasticities for the regressions on the subsamples is thus slightly higher than would be expected from the overall elasticity estimated in equation 1.

Apart from the elasticity estimates, the subsamples confirm the expected signs on the control variables for deductions and gains and losses on other assets. The only unexpected sign arises in the smallest portfolio class for the coefficient on carry-over and losses on other assets, but that coefficient is not statistically significant.

Why does the top end of the wealth distribution respond so much more strongly to variations in tax rates? Two possibilities come to mind. First, the potential absolute variation in tax rates is much greater for those who are wealthiest. This is simply because their highest potential tax rate is much larger than the highest potential rate for those with smaller property incomes (while the lowest possible rate is zero for both groups). This larger range of tax rates suggests that tax minimization is more profitable for wealthier taxpayers because the same change in tax rates means more to the recipient of a larger amount of gains.

Second, it is entirely possible that the incomes and deductions of the well-to-do fluctuate more than those of the less well-off. The equations identify likely causes of lower than average taxable income, and the relevant variables generally have large coefficients of the expected sign. However, it is much more difficult to identify *above* average taxable income when items from all sources are extremely large. Thus taxpayers who have small realizations and high tax rates may be responding to upward fluctuations of income and would time their realizations in the same fashion even if statutory tax rates were lower.

It is possible, with the results of equations 3 through 6 in table 9, to estimate the revenue effect of the capital gains tax provisions of the Revenue Act of 1978 at 1973 income and capital gains levels.[39] Realized stock gains increase by 5.3 percent, with most of that growth at income levels in excess of $50,000. Table 10 shows the resulting change in tax liabilities. Tax revenues are reduced by $692 million, or 5.8 percent, and 65 percent of the tax reduction is received by taxpayers with incomes over $100,000.[40]

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[39] The features included are the reduction of the portion of long-term gains included in adjusted gross income from 50 to 40 percent, and the removal of the excluded portion of long-term gains from tax preferences in the minimum tax and the maximum tax. The change in the law is assumed to have no effect on taxpapers with less than $3,000 of dividends.

[40] Use of the coefficients from either equation 1 or equation 2 would result in a greater revenue loss than that presented in table 10. This revenue loss estimate includes transactions in corporate stock only. It is highly likely that sales of other assets are far less tax sensitive, because stock is the most liquid asset generally purchased to achieve capital gains. For this reason, the actual revenue loss for transactions in all assets is probably significantly greater than the estimate for only corporate stock.

Table 10. Changes in Tax Liability Resulting from the Capital Gains Tax Reductions of the Revenue Act of 1978, 1973 Income Levels

Adjusted gross income (dollars)	*Number of returns*[a] *(thousands)*	*1973 tax liability (millions of dollars)*	*Tax liability under 1978 act (millions of dollars)*	*Change in tax liability (millions of dollars)*	*Change in tax liability (percent)*	*Change in tax liability (dollars per return)*
Less than 0	15.1	11.6	1.9	−9.7	−83.9	−645.4
0–2,500	83.3	0.3	0.0	−0.3	−98.0	−3.6
2,500–5,000	98.8	9.5	8.6	−0.9	−9.1	−8.8
5,000–7,500	106.3	33.6	30.8	−2.8	−8.4	−26.5
7,500–10,000	119.8	85.1	83.7	−1.4	−1.7	−12.0
10,000–15,000	244.7	324.0	317.4	−6.6	−2.0	−27.1
15,000–20,000	310.6	666.6	652.4	−14.3	−2.1	−46.0
20,000–25,000	245.0	726.4	708.2	−18.1	−2.5	−74.0
25,000–30,000	171.4	666.6	657.6	−9.0	−1.4	−52.6
30,000–50,000	329.3	2,316.9	2,241.8	−75.2	−3.2	−228.2
50,000–100,000	171.6	2,748.6	2,647.2	−101.5	−3.7	−591.5
100,000–200,000	48.0	1,964.6	1,843.8	−120.8	−6.1	−2,518.8
200,000–500,000	11.6	1,239.7	1,101.5	−138.2	−11.1	−11,880.3
500,000–1,000,000	1.7	495.1	413.6	−81.5	−16.5	−48,030.0
1,000,000 and over	0.6	546.2	434.6	−111.6	−20.4	−181,501.1
Total or average	1,957.6	11,834.9	11,143.0	−691.9	−5.8	−353.4

Sources: Internal Revenue Service 1973 Sales of Capital Assets File and Individual Tax Model File.

a. With dividends of at least $3,000.

Summary and Conclusions

This paper has presented research in two areas that have been largely unexplored in the past owing to a lack of appropriate data. The bunching of capital gains was found to increase tax liabilities for about 88 percent of those who realized gains. However, this leaves 12 percent who time their realizations of capital gains in years when they are subject to low tax rates because their incomes are lower or their deductions higher than usual. This smaller group disproportionately includes those with large capital gains. The five-year averaging provision in the law already provides some relief for those whose gains are taxed at higher than average rates because of bunching. The other side of the coin—the self-averaging permitted taxpayers through the timing of realizations—is a benefit of the current tax system that is often ignored.

The second new feature of this analysis is the identification of the use of realizations of offsetting capital gains and losses in a single year as a tax-minimization device. The data indicate that higher income taxpayers are likely to realize offsetting gains and losses; such taxpayers have diversified portfolios and may thus realize accrued gains without incurring any tax liability. This tendency is not restricted to relatively liquid assets like stock; rather, other assets were traded in offsetting transactions, and there was a striking tendency for stock losses to be used to offset nonstock gains. These results suggest that taxpayers with small net gains or losses may in many cases have reallocated substantial shares of their portfolios in offsetting transactions, sometimes among several types of assets.

Additional evidence regarding the lock-in effect of the capital gains tax has also been presented. Available estimates of the lock-in effect have been quite imprecise. The most recent estimate indicated an extremely large, continuing lock-in effect. Much of this large measured effect was caused by an incorrect statistical procedure; much of the remainder was the response of taxpayers to fluctuations in their own effective tax rates, as opposed to the level of statutory capital gains rates. This same timing of gains in low tax rate years (and losses in high tax rate years) can be expected whatever the statutory capital gains rates. Once this timing response was removed, the continuing additional realizations to be expected from reductions in capital gains tax rates was found to be much smaller than previous estimates. Further, taxpayers who responded sufficiently to capital gains tax cuts to produce increased federal tax revenue were shown to be a small segment of the population (those with stock portfolios larger than $600,000). As a result, the capital gains tax reduction in 1978 reduced tax revenues on balance.

Appendix A: History of the Capital Gains Tax Provisions

This appendix provides a brief history of the treatment of capital gains under the federal individual income tax. The discussion is limited to the required holding period for preferential treatment; the fraction of capital gains included in adjusted gross income; alternative or additional taxes on gains; the treatment of capital losses; the definition of assets eligible for capital gains treatment; and the deferral of tax on realized gains.[41]

A summary of the holding period, inclusion, alternative tax, and loss-offset provisions is presented in table 11. The capital gains preference has taken the form of an exclusion of part of the gain from adjusted gross income and a limited maximum rate of tax on the gain, provided the gain has been held for some minimum length of time. As is evident from the table, both the minimum holding period required to qualify for the exclusion and the rate of the exclusion itself have changed considerably over the history of the individual income tax. From the introduction of the income tax in 1913 until 1921 there was no preference. In 1922, a 12½ percent alternative tax rate for gains on assets held at least two years was introduced. From 1934 through 1937 long-term gains fell into four categories according to the length of holding period; the longer an asset was held, the smaller the portion of the gain included in taxable income. From 1938 through 1941 there were two categories of long-term gains, with the inclusion rate again lower for assets held longer. The simple long-term–short-term dichotomy was reinstated in 1942 and has endured. In addition to the exclusion, a maximum tax rate on gains was in effect from 1938 until 1968, varying from 15 to 26 percent. Under the 1969 act the maximum rate of 25 percent was restricted to the first $50,000 of long-term gain; it was repealed entirely for tax years beginning in 1979.

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41. More complete, though dated, treatments of these questions are available in David, *Alternative Approaches to Capital Gains Taxation;* and *The Federal Tax System: Facts and Problems,* Committee Print, Joint Economic Committee, 88 Cong. 2 sess. (GPO, 1964).

Since 1969 there have been, under certain circumstances, additional taxes on capital gains. The first of these, the so-called minimum tax, was designed to increase the tax on large long-term capital gains. The excess of the excluded portion of long-term gains (plus certain other preferences) over certain exemptions and deductions was taxed at a flat rate (10 percent through 1975 and 15 percent thereafter).[42] Beginning in 1979 the excluded portion of capital gains was removed from the minimum tax base and added to the the base of a new alternative minimum tax, which also included all of adjusted gross income less personal exemptions and itemized deductions claimed for medical expenses and casualty losses. The alternative minimum tax base was subjected to a progressive tax rate schedule that ranged from 10 to 25 percent. The final tax liability is the ordinary tax or the alternative minimum tax, whichever is greater.[43] The premise of the alternative minimum tax is thus that the tax liability should not be less than some fraction of gross income, unless extraordinary medical expenses or casualty losses significantly reduce the ability to pay.

Because capital gains receive preferential treatment, some taxpayers expend considerable legal effort to convert ordinary income into capital gains. The Internal Revenue Service and the Congress have retaliated with legislation and regulations. The result is a legal battleground that encompasses over half of the internal revenue code and a large fraction of the workload of tax administrators.

Capital gains were first defined in the law in 1922, when the preferential treatment of long-term gains began. The principles behind the definition have remained the same ever since. The law first defines capital assets as property, and then excludes certain types of property from that definition. The two most important exclusions are the incomes received in the ordinary course of business (such as the sale of a manufacturer's product)

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[42] As of 1979, only tax preference items in excess of one-half of ordinary tax liability or $10,000, whichever was larger, were subject to the minimum tax. Tax preference items other than the excluded half of long-term capital gains included excess itemized deductions, accelerated depreciation on low-income rental housing or other real property, accelerated depreciation on personal property, amortization of pollution control or child care facilities, stock options, bad debt reserves of financial institutions, depletion, and intangible drilling costs.

[43] Technically, the alternative minimum tax is equal to the excess of that tax, computed on the alternative minimum tax base and the 10–25 percent rate schedule, over the ordinary tax, computed in the usual way; the taxpayer then pays the ordinary tax plus the alternative minimum tax, if any.

Table 11. History of the Capital Gains Provisions under the Federal Individual Income Tax

Tax year or period	Holding period	Percent of gain taxed as ordinary income	Alternative tax (highest rate on long-term gains)	Treatment of losses
1913–15	All	100	None (highest rate: 7 percent)	Not deductible
1916–17	All	100	None (highest rate: 15 percent in 1916, 65 percent in 1917)	Deductible only from capital gains
1918–21	All	100	None (highest rate: 77 percent in 1918, 73 percent in 1919–21)	Deductible in full from income of any kind
1922–23	2 years or less	100	None	Deductible in full from ordinary income, but not from capital gains
	Over 2 years	100	12½ percent; but total income tax must be no less than 12½ percent of total net income	Deductible in full from income of any kind
1924–31	2 years or less	100	None	Deductible in full from income of any kind
	Over 2 years	100	12½ percent	Creditable at 12½ percent, provided total income tax is no less than if losses were deducted in full from ordinary income
1932–33	2 years or less	100	None	Losses from stocks and bonds deductible only from gains on stocks and bonds. Other losses deductible in full from income of any kind
	Over 2 years	100	12½ percent	Creditable at 12½ percent, provided total income tax is no less than if losses were deducted in full from ordinary income
1934–37	1 year or less	100	None	Net losses, reduced by the appropriate inclusion rate based on the holding period, deductible to the extent of included capital gains plus $2,000
	Over 1 year to 2 years	80	None (highest rate: 50.4 in 1934–35, 63.2 in 1936–37)	

	Over 2 years to 5 years	60	None (highest rate: 37.8 in 1934–35, 47.4 in 1936–37)	
	Over 5 years to 10 years	40	None (highest rate: 25.2 in 1934–35, 31.6 in 1936–37)	
	Over 10 years	30	None (highest rate: 18.9 in 1934–35, 23.7 in 1936–37)	
1938–41	18 months or less	100	None	Deductible only from gains on assets held 18 months or less; excess losses to the extent of net income may be carried forward to the next tax year
	Over 18 months to 2 years	66⅔	30 percent of included gain (highest rate: 20 percent in 1938–39 and 1941, 22 percent in 1940)	Net loss reduced by the appropriate inclusion rate deductible from other income or creditable at 30 percent, whichever gives the greater tax
	Over 2 years	50	30 percent of included gain (highest rate: 15 percent in 1938–39 and 1941, 16.5 percent in 1940)	
1942–51	6 months or less	100 (of excess over 50 percent of long-term loss, if any)	None	Net loss (short-term loss plus 50 percent of long-term loss, or excess of short-term loss over 50 percent of long-term gain, or excess of 50 percent of long-term loss over short-term gain) deductible from included gain plus $1,000 of ordinary income; excess carried forward for 5 years as short-term loss
	Over 6 months	50 (less short-term loss, if any)	25 percent (26 percent effective September 1, 1951)	
1952–63	6 months or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of long- and short-term loss, or excess of short-term loss over long-term gain, or excess of long-term loss over short-term gain) deductible from other income up to $1,000; excess carried forward for 5 years as a short-term loss
	Over 6 months	50 (of excess over short-term loss, if any)	26 percent (1952–53) 25 percent (1954–63)	

Table 11 (*continued*)

Tax year or period	*Holding period*	*Percent of gain taxed as ordinary income*	*Alternative tax (highest rate on long-term gains)*	*Treatment of losses*
1964–69	6 months or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of long- and short-term loss, or excess of short-term loss over long-term gain, or excess of long-term loss over short-term gain) deductible from other income up to $1,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward indefinitely as long-term loss; short-term loss carry-overs used first
	Over 6 months	50 (of excess over short-term loss, if any)	25 percent	
1970–76	6 months or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of short-term loss and 50 percent of long-term loss, or excess of short-term loss over long-term gain, or 50 percent of excess of long-term loss over short-term gain) deductible from other income up to $1,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward indefinitely as long-term loss; short-term loss carry-overs used first
	Over 6 months	50 (of excess over short-term loss, if any)	25 percent on first $50,000 of gain only. Additional tax of 10 percent (15 percent in 1976) on excluded half of gain under certain circumstances (highest rate: 0.3221375 in 1970; 0.3875 in 1971; 0.455 in 1972–75; 0.49125 in 1976)	
1977	9 months or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of short-term loss and 50 percent of long-term loss, or excess of short-term loss over long-term gain, or 50 percent of excess of long-term loss over short-term gain) deductible from
	Over 9 months	50 (of excess over short-term loss, if any)	25 percent on first $50,000 of gain only. Additional tax of 15 percent	

			on excluded half of gain under certain circumstances (highest rate: 0.49125)	other income up to $2,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward in definitely as long-term loss; short-term loss carry-overs used first
1978	1 year or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of short-term loss and 50 percent of long-term loss, or excess of short-term loss over long-term gain, or 50 percent of excess of long-term loss over short-term gain) deductible from other income up to $3,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward indefinitely as long-term loss; short-term carry-overs used first
	Over 1 year	50 (40 after October 31 only) (of excess over short-term loss, if any)	25 percent on first $50,000 of gain only. Additional tax of 15 percent on excluded half of gain under certain circumstances (highest rate: 0.49125 January 1–October 31; 0.349 November 1–December 31)	
1979	1 year or less	100 (of excess over long-term loss, if any)	None	Net loss (sum of short-term loss and 50 percent of long-term loss, or excess of short-term loss over long-term gain, or 50 percent of excess of long-term loss over short-term gain) deductible from other income up to $3,000; excess short-term losses carried forward indefinitely as short-term loss; excess long-term losses carried forward indefinitely as long-term loss; short-term loss carry-overs used first
	Over 1 year	40 (of excess over short-term loss, if any)	Graduated additional tax on full amount of gains under certain circumstances (highest rate: 28 percent)	

Sources: U.S. Department of the Treasury, *Federal Tax Rates, 1913 to 1940* (Government Printing Office, 1941), pp. 530–32, and *Federal Tax Rates, 1940 through 1950* (GPO, 1951), pp. 277–78; *Revenue Act of 1951*, H. Rept. 586, 82 Cong. 1 sess. (GPO, 1951); *Brief Summary of the Provisions of H.R. 8363, "The Revenue Act of 1964,"* Committee Print, Senate Committee on Finance, 88 Cong. 2 sess. (GPO, 1964); *Tax Reform Act of 1969*, H. Rept. 91-782, 91 Cong. 1 sess. (GPO, 1976), pp. 162–69; *Tax Reform Act of 1976*, H. Rept. 94-1515, 94 Cong. 2 sess. (GPO, 1976), pp. 232–35; and *General Explanation of the Revenue Act of 1978*, Committee Print, Joint Committee on Taxation, 96 Cong. 1 sess. (GPO, 1979), pp. 251–60.

and gains on property used in a trade or business. In both of these general categories, however, numerous exceptions have been made. For example, in 1943 gains from sales of timber were defined as capital gains even though the timber might be sold routinely in the ordinary course of business. Gains from sales of coal (1951) and iron ore (1964) royalty rights were defined as capital gains, even though the royalties themselves would have been taxed to the original owner as ordinary income.[44] Likewise, certain business assets can be sold for capital gains so long as recovery of depreciation already taken against ordinary income is taxed in full. Taxpayers continue to test the capital gains definition with their particular circumstances, and the resolution of each case adds to the already large body of legislation, regulations, rulings, and case law.

Just as capital gains are not added in full to taxable income, so capital losses are not subtracted in full. From 1913 through 1916 capital losses could not be offset against capital gains at all. Since that time, the law has been more generous—allowing losses to be offset against gains, allowing net losses to be carried forward to later tax years, or allowing the offset of some (in certain years, all) of capital losses against ordinary income.[45] Treatment of losses is an important economic issue because risk-taking is affected by the treatment of both successful and unsuccessful risks.

The tax law has always recognized capital gains when they are realized rather than as they accrue. This presents an important opportunity for tax reduction by holding rather than selling appreciating assets. By postponing sale, the owner of appreciating property implicitly allows all of his investment to earn its current market return instead of selling the asset and reinvesting only the after-tax proceeds at the market rate. Certain provisions of the tax code extend the opportunity of deferral to involuntary conversions, exchanges of property of like kind, certain exchanges of insurance policies, and certain exchanges of securities in corporate organizations, reorganizations, and mergers. Still another opportunity is probably the most common: the deferral of recognition of the fully reinvested gain on owner-occupied homes.

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[44] *Revenue Act of 1951*, H. Rept. 586, 82 Cong. 1 sess. (GPO, 1951); and *Brief Summary of the Provisions of H.R. 8363, "The Revenue Act of 1964,"* Committee Print, Senate Committee on Finance, 88 Cong. 2 sess. (GPO, 1964), p. 6.

[45] The offsetting of short-term losses against long-term gains is itself an issue, since all of short-term but only part of long-term gains are included in adjusted gross income. From 1942 through 1951 short-term losses were deducted from *the portion of long-term gains that was included* in adjusted gross income. This allowed taxpayers to realize long-term gains and half as much in short-term losses and pay no tax; it also meant that taxpayers realizing equal amounts of short-term gains and long-term losses were taxed on half their gains at ordinary rates. Since that time, short-term losses have been deducted from *total* long-term gains before the included portion is computed.

One of the most significant deferral opportunities is available through the transfer of assets either by gift or at death. Property transferred by gift is subject to federal gift taxation, but no income tax is assessed on the accrued gain. The donee receives the property subject to the donor's basis with an adjustment for gift taxes paid, and if the donee chooses to sell the property, capital gains taxes are collected on the entire appreciation from the date the donor acquired it. Property transferred by bequest is subject to the federal estate tax, but again the appreciation goes untaxed under the income tax. Further, the donee accepts as the basis the value of the property as of the time of bequest, meaning that any appreciation accrued during the donor's lifetime is never subject to capital gains tax. The deferral of taxation through gift or bequest is considered a major problem by some tax experts, because appreciating property can change hands between generations without capital gains tax, thus increasing the concentration of wealth. Further, property owners may keep assets that are economically inferior to available alternatives because the present value of the tax savings at death will exceed the yield differential between the assets, capitalized and discounted over the owner's expected lifetime.

Appendix B: Historical Data on Capital Gains

Realizations of capital gains are extremely volatile over time, as is shown in table 12. Several offsetting factors are at work. When assets appreciate and gains accrue more rapidly, some taxpayers choose to realize those gains rather than leave them at risk. Taxpayers with accrued losses have incentives to realize them in order to offset gains, and to move them into apparently more profitable assets. When asset prices are stable or falling, there is less appreciation to realize, but stagnant and falling incomes with no gains encourage realizations to maintain consumption levels. Losses are also likely to be realized to maintain consumption, but published statistics generally do not reveal the true extent of loss realizations because of the limitation on loss offsets against ordinary income.

Table 12 indicates that realizations are significantly correlated with the state of the economy and of the stock market. Net gains are significantly positively correlated with both the level of corporate profits and stock

Table 12. Realized Net Capital Gains and Net Capital Losses on Individual Income Tax Returns and Selected Economic Indicators, 1954–77

Year	Net gains (thousands of dollars)	Net losses (thousands of dollars)	Corporate profits (billions of dollars)	Standard and Poor's index	Percent change, gross domestic product deflator	Real rate of growth of GNP (percent)	Baa corporate bond rate (percent)
1954	3,731,862	379,446	37.8	29.69	1.4	−1.3	3.51
1955	5,126,350	375,213	46.7	40.49	2.2	6.7	3.53
1956	4,991,131	438,465	45.9	46.62	3.2	2.1	3.88
1957	4,128,228	642,695	45.4	44.38	3.4	1.8	4.71
1958	4,879,114	549,110	40.8	46.24	1.6	−0.2	4.73
1959	6,796,602	522,115	51.2	57.38	2.2	6.0	5.05
1960	6,003,859	704,284	48.9	55.85	1.7	2.3	5.19
1961	8,290,879	670,085	48.7	66.27	0.9	2.5	5.08
1962	6,821,421	1,050,393	53.7	62.38	1.8	5.8	5.02
1963	7,468,326	1,019,344	57.6	69.87	1.5	4.0	4.86
1964	8,909,143	969,991	64.2	81.37	1.6	5.3	4.83
1965	11,069,464	888,606	73.3	88.17	2.2	5.9	4.87
1966	10,960,261	1,018,979	78.6	85.26	3.3	5.9	5.67
1967	14,593,683	911,798	75.6	91.93	2.9	2.7	6.23
1968	18,853,870	864,221	82.1	98.70	4.5	4.4	6.94
1969	16,078,215	1,494,887	77.9	97.84	5.0	2.6	7.81
1970	10,655,553	1,648,870	66.4	83.22	5.4	−0.3	9.11
1971	14,558,580	1,403,581	76.9	98.29	5.1	3.0	8.56
1972	18,396,678	1,321,387	89.6	109.20	4.1	5.7	8.15
1973	18,200,682	1,529,396	97.2	107.43	5.8	5.5	8.24
1974	15,377,899	1,907,774	86.5	82.85	9.7	−1.4	9.50
1975	15,799,165	1,727,272	107.9	86.16	9.6	−1.3	10.61
1976	20,207,101	1,645,248	141.4	102.01	5.2	5.7	9.75
1977	23,363,333	2,586,729	159.1	98.20	5.9	4.9	8.97

Sources: Internal Revenue Service, *Statistics of Income: Individual Tax Returns*, various years; *Economic Report of the President, 1979*, tables B-2, B-3, B-19, B-65, and B-88.

market indexes, as are changes in net gains.[46] Profits and stock market indexes are also positively correlated with the absolute value of net losses, indicating that asset holders respond to rising prices by cashing in their losses for more profitable reinvestment or by offsetting their gains with losses. Upward movements in profits and the stock market are correlated with smaller loss realizations, however, because rising markets wipe out some accrued losses. Faster growth and acceleration of growth of the gross national product are associated with increased realization of net gains. High interest rates are associated with greater net gains and net losses; rising interest rates are associated with decreases in realizations of net gains and increases in realizations of net losses. Net gains and net losses tend to be larger when the inflation rate is higher; an acceleration of inflation is associated with an increase in net losses.

Comments by James W. Wetzler

Whenever it cuts the capital gains tax rate, Congress claims that the additional transactions induced by the tax cut will prevent any decline in revenues, and whenever it raises the tax rate, Congress claims credit for the assumed revenue gain with little reference to possible lock-in effects. The most recent cycle in congressional attitudes on lock-in lasted only two years. Clearly, empirical research to narrow the range of disagreement on this issue is a high priority, and both Joseph Minarik and Martin Feldstein, Joel Slemrod, and Shlomo Yitzhaki, on whose work Minarik builds, should be commended for undertaking the assignment.[47]

How much do economists really know about the extent to which changes in tax rates on capital gains affect investors' decisions to sell assets? I am afraid that, despite the best efforts of Minarik and Feldstein-Slemrod-Yitzhaki, the answer is, relatively little.

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[46] This reflects the important role of gains on corporate stock in total gains. In 1962 stock transactions accounted for $7.1 billion of $17.3 billion total gross gains and $4.1 billion of $6.3 billion total gross losses. Internal Revenue Service, *Statistics of Income—1962, Supplemental Report: Sales of Capital Assets Reported on Individual Income Tax Returns*, table 1, p. 21. The inferences discussed here are based on correlation coefficients rather than a general regression model because the various measures of economic conditions are highly collinear among themselves. Without a richer body of time series data, these results should be taken as tentative.

[47] Feldstein, Slemrod, and Yitzhaki, "Effects of Taxation."

Let me start with the relevant theory, which logically should precede any empirical work but which is omitted by both Minarik and Feldstein-Slemrod-Yitzhaki. It is easy to show that a wealth-maximizing investor who owns an asset that has appreciated in value will not sell that asset and switch to an alternative asset unless the expected rate of return on the alternative investment is enough higher than that on the original asset to justify the capital gains tax on the appreciation and other costs of making the transaction. The extra rate of return on the alternative asset needed to induce the switch is proportional to the capital gains tax rate and to the ratio of the appreciation on the asset to its value. If there is a step-up in basis at death, the needed excess return also varies inversely with life expectancy.[48]

Investors' expectations about rates of return on different assets are unobservable, of course. Therefore, to derive any testable hypotheses, some assumptions must be made about how these expectations are formed and how they change over time. For example, it might be assumed that, having just bought an asset, an investor expects it to have a higher rate of return than any alternative assets but that, as time passes, his expectations about the rate of return on his own asset and on alternative assets follow random walks. Eventually, these fluctuations in expectations will cause some alternative asset to improve sufficiently in the investor's estimation to overcome his original preference, the transactions cost of making a switch, and any applicable tax consequences. At this point, the investor switches to the new asset.

The result of this exercise would be a theory of investors' holding periods. For any particular asset on which there was a given amount of unrealized appreciation and which was owned by an investor with a given tax rate, the holding period would be a random variable. A change in the capital gains tax rate would change the mean, and probably the other moments, of the probability distribution of holding periods.

A final step in building the theory should be to show how a given change in the probability distribution of holding periods would be translated into a change in realizations of capital gains. Presumably, a discrete shortening of the mean holding period, perhaps as a result of a cut in the capital gains tax rate, would lead to an initial surge of realizations followed by a decline to a level above the original starting point. In the long run the effect on realizations of a given shortening of the holding period will depend on the rate at which assets appreciate.[49]

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[48] See Holt and Shelton, "The Lock-In Effect of the Capital Gains Tax," and Wetzler, "Capital Gains and Losses," pp. 135–37.

With this as background, I turn to Minarik's paper. In the appendix Minarik presents historical data on realizations of capital gains and losses, but he does not use these data to draw conclusions about the effects of tax changes on realizations. For what it is worth, a simple comparison of changes in tax rates and changes in aggregate realizations of gains gives little support to those who believe that tax rates strongly influence realizations. The explicitly temporary 7.5 percent increase in capital gains tax rates from the 1968 income tax surcharge, which took effect in midyear, did not prevent a large rise in realizations in that year. The 1977 data show that realizations of net gains rose 10 percent over 1976 despite the sizable capital gains tax increase enacted in 1976 and a weak stock market. The behavior of realizations after the Tax Reform Act of 1969 is hard to interpret because that act gave investors a crazy quilt of incentives by phasing in an increase in tax rates on large gains of high-bracket taxpayers, extending and phasing out the surcharge, and enacting a minimum tax effective in 1970. Thus it is hard to evaluate the meaning of the sharp drop in realizations in 1970 or the equally sharp increases in 1971 and 1972.[50]

One interesting empirical result presented by Minarik is that a sizable number of investors make use of their flexibility about when to realize a gain to even out their income over time. It is not clear whether these taxpayers are responding to the potential tax savings resulting from this self-averaging or whether they sell assets when taxable income is low just because that is when they need the cash. In either case, Minarik's results suggest that the bunching problem is less serious than has been assumed and that, among capital gains recipients, some of the variation in the marginal tax rate applying to the first dollar of gain reflects transitory changes in income.

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[49] These calculations are relatively simple under the assumption that the holding period changes from one value to another but are considerably more difficult when an entire probability distribution of holding periods is shifting and when adjustments are made for the effect of any change in holding periods on the amount of gain passing tax-free at death.

[50] Since this paper was written, data on capital gains realized in 1979 have become available. They show a sufficient increase in realizations to make the actual revenue raised by the capital gains tax in 1979 approximately what might have been expected under the law in effect before the 1978 tax cut. This outcome is closer to the result predicted by Minarik's equation than to that predicted by Feldstein-Slemrod-Yitzhaki. The 1979 data indicate the short-run response to the tax cut, of course, not the steady-state response.

The major part of Minarik's paper is a reappraisal of Feldstein-Slemrod-Yitzhaki's highly publicized study claiming that a cut in the maximum capital gains tax rate from its 1973 level to 25 percent would lead to a threefold increase in realizations of gains. (Presumably, a cut to 25 percent from the higher 1977 tax rates would lead to a still larger increase in realizations.) The Feldstein-Slemrod-Yitzhaki study consisted of cross-section regressions relating an individual's sales of corporate stock and net gain realized on corporate stock to his marginal capital gains tax rate. The regressions were estimated from the Internal Revenue Service's 1973 study of individual transactions in capital assets.

Both Minarik and Feldstein-Slemrod-Yitzhaki should be faulted for proceeding with empirical tests without first having straightened out the relevant theory. I suspect that, once the theory of investors' holding periods and the precise link between holding periods and realizations is worked out, the system will have a reduced form in which an individual's realized gains is a dependent variable and his marginal tax rate is one of the independent variables. At that time, regressions such as those of Minarik and the earlier study may be useful in estimating some of the parameters of the system. In isolation from the relevant theory, however, their results are very hard to interpret.

For example, the short-run response of realizations to a change in the tax rate should be larger than the long-run response. Do Feldstein-Slemrod-Yitzhaki's and Minarik's coefficients measure the short-run effect, the long-run effect, or something in between? Also, a transitory decline in income affects realizations both by lowering the tax rate and by creating a need for cash. Thus if much of the variation in marginal tax rates reflects transitory changes in income, it may be impossible to get an unbiased estimate of even the short-run effect of a ceteris paribus change in tax rates.

Under these circumstances, the main contribution of Minarik's regressions is that they bring the estimated coefficient of the tax rate variable down from the stratospheric height it attained in the Feldstein-Slemrod-Yitzhaki study. The latter completely ignored the question of whether a short-run or a long-run response was being estimated. Minarik, in contrast, adds several independent variables designed to control for factors causing temporary changes in marginal capital gains tax rates in an attempt to purge the tax rate variable of transitory influences. These new variables raise the coefficient of the tax rate variable for people with medium-sized portfolios and lower it for people with large portfolios. Only for people with very large portfolios do Minarik's equations confirm Feldstein-Slemrod-Yitzhaki's conclusion that a cut in capital gains tax rates will increase realizations enough to raise revenue.

Some of Minarik's independent variables, however, probably represent something other than a measure of transitory changes in tax rates. For example, the correlation between charitable contributions and capital gains is more likely to result from the propensity of people with gains to make contributions than from the effect of contributions in temporarily lowering the marginal tax rate. It would be better to drop that variable. Business losses may affect the realization of gains not only by temporarily lowering the marginal tax rate but, more significantly, by creating a need for cash.

Problems arise in measuring the marginal capital gains tax rate. For taxpayers with capital losses or loss carry-forwards, the marginal tax rate for a capital gain is zero in the year the gain is realized; however, realization of the gain would reduce the loss carry-forward available for future years. Thus the true marginal rate for these taxpayers is the present value of the expected future tax benefit that would otherwise have been obtained from the forgone loss carry-forward. To the extent that there are errors in measuring the tax rate variable, the size of its coefficient will be biased downward.

Another issue is the quality of the underlying data. My understanding is that the 1973 capital asset tapes are of poor quality in the sense that, for many individual transactions, the reported gain does not equal the reported sale price minus the reported purchase price and that the reported total gain of many taxpayers does not equal the sum of the gains and losses from the individual transactions. I would be interested in knowing what efforts both Minarik and Feldstein-Slemrod-Yitzhaki made to deal with these problems.

I conclude from all this that we still know relatively little about the magnitude of changes in realizations, in both the short and the long run, that would result from a change in capital gains taxes. As the most promising direction for further research, I suggest more theoretical work on how holding periods are determined and how changes in holding periods are translated into changes in aggregate realizations, followed by statistical tests with the cross-sectional data to relate variation in holding periods to marginal capital gains tax rates. My guess is that a better approach to estimating the effect of tax changes on realizations will prove to be equations that use tax rates to explain variations in holding periods across individuals, rather than the variation in realizations per se.

TESTIMONY OF

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Before the

Subcommittee on Monetary and Fiscal Policy
Joint Economic Committee

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Like just about everything else in this imperfect world, the flat rate income tax has its advantages and its disadvantages. The purpose of my testimony today is to outline some of the pluses and the minuses for the Subcommittee. But before we can examine the flat rate tax, we need to define carefully what we mean.

For the purpose of this statement, the flat rate income tax is a single rate tax on an income base broader than that of current law. As the numerous self-described flat tax bills make clear, many approaches fit this general description. It is also evident that one could introduce a flat tax rate without broadening the tax base, or vice versa. This latter distinction is important; even if you should decide that a single tax rate is not the best approach, we would still have other things to talk about today.

To analyze the flat rate tax, it is helpful to separate the effects of the base broadening from those of the flat rate itself. The first part of my testimony will deal with the pros and cons of broadening the tax base. The second part will incorporate the single tax rate into the analysis.

BROADENING THE INCOME TAX BASE -- GOALS AND POSSIBLE EFFECTS

The current interest in the flat rate tax has brought along with it renewed interest in broadening the tax base. The idea of "closing loopholes," "repealing tax expenditures," or "broadening the tax base" -- whichever one chooses to call it -- is certainly not new. It is the core of a school of thought of tax policy that used to be called "tax reform" and was identified more than any other influence with the Tax Reform Act of 1976. The Senate Finance Committee included several base broadening steps in its recent tax bill.

As the Subcommittee will hear many times before its hearings are over, the three goals of any tax system are efficiency, simplicity, and fairness. These goals have been universally recognized for decades, and it is not surprising that they should be widely cited in the current debate. This section next will analyze base broadening according to these three criteria.

Efficiency

A broad tax base has long been thought a necessary condition for efficient taxation. The current legal definition of "gross income" thus includes ". . . all income from whatever source derived . . ." (Section 61a); but over recent years many exceptions have crept into the law. These exceptions reduce economic efficiency in two ways.

First, if the income from some particular economic activity is either excused from taxation, or taxed at some preferential rate, then that activity is more attractive to taxpayers. Resources will flow into the tax-preferred activity from other activities with higher pretax returns, with the result that the real value of the economy's output is reduced. Everyone but the direct beneficiaries will be worse off in the long run. Some observers would argue with this generalization, on the grounds that society sometimes errs in its preferences; for example, they might say that people are shortsighted, and so we need a tax preference for retirement savings. Those who believe in the desirability of free markets, however, would prefer the marketplace to any political judgment of what activities to encourage.

A second efficiency cost occurs when these exceptions to the tax base begin to multiply and grow. As tax-preferred income increases as a share of the total and fully taxed income therefore shrinks, the tax rates needed to meet the government's revenue needs rise. Therefore, the after-tax reward for all non-tax-preferred activities -- which generally includes work and much of saving — falls. The incentive for socially productive economic activity is reduced, and some unproductive investments (or "tax shelters") use particular tax preferences to earn risk-free after-tax profits.

The solution to these problems of economic inefficiency is to broaden the tax base by repealing the tax preferences for the various heretofore favored types of income and expenditure. Without the tax preferences, resources would be allocated according to the before-tax social return, and marginal tax rates could be reduced.

Base broadening steps must be considered carefully, however. The Congress might be asked to give up the use of tax preferences in the pursuit of some socially desirable goals: saving for retirement is an example. Also, it would be essential to retain in the law those deductions that are necessary to measure income correctly. Failure to keep such provisions would result in an income tax on more than some people's income, causing possibly serious distortions. For example, an income tax on a small businessman that does not allow a deduction for the depreciation of his business computer or other office equipment would require him to pay tax on receipts that merely cover legitimate business expenses. The same could be said of denying an interest deduction to a businessman who borrows to carry inventory. In the extreme, such excessive base broadening could result in the assessment of an income tax on a business that only breaks even, or even one that loses money. The end result would be to discourage business undertakings in which the nondeductible expenses are important. So, while broadening the tax base generally increases economic efficiency, this benefit is lost if the tax base is broadened beyond the measure of true economic income.

Simplicity

Broadening the tax base is often portrayed as the ultimate simplification of the income tax. Eliminating all those loopholes, some would argue, could trim the size and complexity of tax returns radically and put all the tax lawyers and accountants out of work. But these effects may not be so clear-cut.

It is certainly true that repealing some tax expenditures would simplify the tax forms. Prohibiting itemized deductions, for example, would eliminate Schedule A and obviate the need for keeping records on medical expenses, charitable contributions, and so on. Likewise, repealing the energy conservation credits would eliminate Form 5695 and the need for carrying conservation expense figures from year to year. Taxing long-term capital gains in full would end the complex distinction between long- and short-term gains. In general, repealing deductions, credits, and partial exclusions would simplify the tax filing process. (Increasing the zero bracket amount, which used to be called the "standard deduction," also simplifies tax filing for taxpayers who no longer need to itemize their deductions.)

Not all base broadening steps would simplify the tax system, however. In particular, taxing any type of income that is now exempt from taxation would complicate the system. For example, taxing employers' contributions for employees' life and health insurance premiums would add lines to the tax forms and would force employees to come up with cash to pay taxes on income they did not receive in cash. Taxing employers' pension contributions would be even more complicated for a number of reasons: employees whose pension rights were not vested would have to be treated differently from those who were vested; a transition would be necessary when vesting occurred; and employees who were covered by defined benefit plans might in fact receive rights to future income that differ in present value from the current amount of contributions. Putting "floors" under these items -- that is, making some small amount tax exempt but any excess over that amount taxable -- would complicate the system still further. Taxing all or part of social security benefits would force many of the low-income elderly who are now excused from filing to fill out the tax forms; this would add to the paperwork load of the system. The list could go on and on.

So in terms of simplicity, broadening the tax base could help or hurt, and probably would do some of both. It is unavoidable that some of the complexity of our highly developed economy is reflected in our tax system. We can achieve utter simplicity in our tax laws only by disregarding many very relevant aspects of the real world.

Fairness

Fairness is one of the objectives of base broadening most often mentioned. Tax preferences for ostensibly unimpeachable purposes can sometimes be used simply for tax avoidance by people with some control over their financial affairs, while other taxpayers with less resources or inferior advice cannot take such advantage. The result has been a widespread questioning of the integrity of the tax system and possibly even a reduction in voluntary compliance. Eliminating the tax preferences that can cause extreme differences in tax burdens among similarly situated taxpayers could help to restore confidence in the fairness of the tax system.

One has to consider some caveats to the fairness effects of base broadening as well. Some variation in tax burdens within income groups occurs today not because of manipulative tax avoidance by sophisticated investors but because of such everyday activities as home purchasing and charitable giving. Eliminating those tax preferences would narrow the variation in tax burdens, but it could also have detrimental side-effects. The tax incentive for charitable giving -- a provision meant to benefit society -- would be ended. Home values would fall, and the tax burdens of homeowners would rise. This last effect might be particularly painful, because homeowner deductions are tied to long-term contractual mortgage obligations, and many homeowners would therefore have limited flexibility in their family budgets to absorb the resultant tax increases in the short term.

So in general, base broadening can yield substantial efficiency, simplicity, and fairness benefits; but those benefits must all be qualified to some extent. The efficiency case for base broadening is very strong, in that eliminating tax influences in the marketplace would cause resources to be allocated to their best uses and marginal tax rates to be reduced; but it would be necessary to retain deductions required for a true measure of income. Eliminating deductions and credits would simplify the tax system, but adding hitherto missing income items to the tax base would complicate the system. Finally, fairness suggests that all income be taxed in the same way, but some persons who are by no means abusers of the current system -- such as homeowners -- might find the elimination of tax preferences distinctly unfair. Others might wish to retain the many tax subsidies for particular socially desirable activities. The lesson from all of this -- unsatisfying though it may be -- is that easy answers are hard to come by; one has to broaden the tax base with care.

With this background on the broadening of the tax base, how does the use of a single tax rate in the current flat rate proposals affect the picture?

A SINGLE TAX RATE -- GOALS AND POSSIBLE EFFECTS

As I noted at the outset, the effects of broadening the income tax base and of changing to a single tax rate can be logically separated. A close examination suggests that some of the effects of base broadening have been attributed to the flat tax rate, while other effects of the flat tax rate have been exaggerated or misunderstood. The flat rate can be evaluated according to the same three criteria as was base broadening: efficiency, simplicity, and fairness.

Efficiency

It is sometimes alleged that tax rate progressivity discourages work, saving, and investment, and encourages tax sheltering; from this standpoint, a changeover to a flat rate is a solution to these problems. In fact, however, it is the level of the marginal tax rates -- not the fact that they are progressive -- that reduces incentives. A simple though admittedly extreme example should make this clear. One could imagine a progressive income tax with ten tax rate brackets ranging from 1 to 10 percent that would have little or no disincentive effect on taxpayers. On the other hand, a flat rate tax with a 50 percent rate might have considerable disincentive effects. Thus, what determines the efficiency cost of any income tax is the level of the rate or rates, which, for a given revenue, is determined by the size of the tax base. How low the marginal rates can be made in any specific tax system, be it flat rate or progressive, is an empirical question.

Using a flat tax rate would unquestionably raise lower-income people's marginal tax rates and lower those of high-income taxpayers. (To collect the same total revenue on the same tax base with graduated rates, the bottom bracket rates could be made lower, but the top rates would have to be higher to make up the resulting revenue loss.) The net effect on incentives is thus very hard to predict. The outcome is even more uncertain if the flat rate tax shifts the tax burden from upper- to lower-income groups before any taxpayers actually respond by changing their behavior. In that case, the marginal rate change (in technical terms, the "price effect") and the tax liability change (the "income effect") would give taxpayers opposite incentives, making the result even more ambiguous.

(To illustrate: A high-income self-employed professional divides his time between working and vacationing. A flat rate tax is enacted; his marginal tax rate falls from 50 to 19 percent, and he also receives a $20,000 tax cut. Does he work more, to take advantage of his higher after-tax wage? Or does he use his extra $20,000 to finance longer and more expensive vacations? Economists have found these counteracting incentives from plausible tax policy changes very nearly to cancel each other out.)

Some improvements of economic efficiency would be caused solely by the flat rate tax; the advantages of tax shelters that move taxable income from high- to low-income years and from high- to low-income taxpayers would be reduced, and complicated court cases in these areas would be less numerous. However, these tax shelter effects stand to influence a more restricted group than the changes in marginal tax rates.

To sum up, it is useful to distinguish between the efficiency effects of broadening the tax base and those of applying a flat tax rate. If all else were equal, using a flat rate would permit reducing some marginal tax rates only at the expense of raising others. On the other hand, broadening the tax base would permit the reduction of all marginal tax rates.

Simplicity

Taxing all of income at a flat rate would simplify the income tax in some respects. Use of a single rate would eliminate the need for the tax rate schedules -- Schedules X, Y, and Z at the end of the Form 1040 instructions (example attached);

filers of any type of return (married filing jointly, married filing separately, single, and head of household) would pay the same tax rate. These schedules are now used only by taxpayers with incomes of above $50,000. Also, the income-averaging option -- now used by about 6 percent of all taxpayers -- could be repealed, because taxpayers would no longer pay higher taxes because of the effect of progressive tax rates on fluctuating incomes. Finally, the number of tax-shelter court cases in some areas would shrink somewhat.

Beyond these changes, however, any further simplification from using a single tax rate would be extremely limited. A brief discussion should indicate why.

One claim sometimes made is that a flat tax rate would eliminate the need for the many pages of tax tables in the Form 1040 instructions (example attached). The taxpayer looks at these tables for his type of return and income, and is told his precise tax liability. Though it is claimed that taxpayers could easily compute their own tax liabilities under the flat rate tax, taxpayers have proven to be more accurate in looking up their tax on the tax tables than in making the actual mathematical computations themselves. Thus, it is unlikely that the tax tables would be abandoned even under a flat rate tax.

Another claim for the flat rate tax is that it would simplify the tax return enough to fit on a postcard. This claim seems exaggerated. The space on the current tax return for the taxpayer's name and address, his indication of the type of return he is filing, the number and names of his dependents, and his signature already exceeds the area of a large (5 inch by 8 inch) postcard. Using a single tax rate would not eliminate the need for reporting any of these pieces of information.

In fact, broadening the tax base by eliminating deductions, partial exclusions, and credits would remove some lines from the tax forms, and also eliminate some entire forms. But much of the information now called for on the tax forms is needed so that compliance with the law can be checked from the forms themselves rather than from full-scale audits. Income must be broken down on tax forms by source, which takes up space and adds complexity, but without it spot checking for accuracy of reporting would be impossible. Individual items of dividend and interest income must be enumerated, so that information returns from payers can be matched to them. Omitting these complications in the name of simplicity could make enforcement far more difficult and costly.

A final claim concerning simplification through the flat tax rate is a saving of billions of dollars of federal expenditures for tax administration. These claims too might be exaggerated, because the flat tax rate alone (as opposed to low, graduated rates on a broad base) would do very little to ease tax administration. Computers can determine tax liabilities from the amount of taxable income in microseconds, regardless of whether the tax schedule is flat or graduated. Even the maximum potential for savings in tax administration is limited; the entire IRS budget request for fiscal year 1983 was only $6.25 billion, more than $3 billion of which was payment of credits in excess of tax liability and refunds of interest on overpayments. In other words, closing down the IRS would save only a little over $3 billion. Thus, it is clear that changing to a flat tax rate could save only a small fraction of that figure, at best.

In sum, a flat tax rate would add little to any simplification that base broadening would permit. Expectations of reduced paperwork and administrative costs attributable to base broadening and a flat tax rate should not be too high.

Fairness.

Fairness is the most visible and yet the most elusive criterion in an analysis of the flat tax rate. Inequity seems to be high on the list of Americans' criticism of the present income tax. But fairness is a subjective quality, not quantifiable by the methods that economists apply in other areas. Opinions on a flat tax's fairness will inevitably differ.

To some people, a flat rate tax is the essence of fairness; every taxpayer pays the same fraction of his income in tax. If low-income relief is allowed (in the form of a personal exemption or a standard deduction), then effective tax rates would actually be somewhat progressive. The flat rate tax also has some structural fairness advantages. It would eliminate the problem of "bracket creep" caused by inflation (though indexing exemptions and deductions, if any, would be needed to make the system more immune to inflation). The flat rate would also eliminate the marriage-penalty-related problem of one spouse's pushing the other into higher marginal tax rate brackets.

Other people believe in progressive taxation, that is, taxation at increasing marginal tax rates as income increases. Arguments for progressivity generally rest on the principle of ability to pay. Taxpayers with higher incomes are assumed to buy nonessentials with their last dollars of income; those with lower incomes are assumed to buy more basic items. It might follow, then, that persons with higher incomes could afford to pay tax at a higher rate. Putting the argument another way, the subjective value of the last dollar of a rich man's income is taken to be lower than that of a poor man. Judging the relative strengths of opinion for progressivity and proportionality is difficult. Though a majority of the population appears to favor progressivity on grounds of fairness (58 percent, according to a recent Harris poll, attached), there is probably no agreement within that majority as to just how progressive the tax system should be. On the other hand, the flat rate tax concept is a convenient rallying point for advocates of proportionality. In any event, finding strong support for any particular kind of tax system in heretofore revealed public opinion seems difficult -- given the many diverse options even for the exact design of a flat rate system.

Distinct from the question of fairness in the abstract is the unavoidable comparison of any flat rate tax proposal with current law. A flat rate tax that appeared fair in isolation might increase the tax liabilities of many relatively vulnerable taxpayers. A changeover to a flat rate tax, then, could involve a painful transition in which the "losers" would have to tighten their belts. Policymakers are therefore to some extent prisoners of the current tax law; it might be painful to impose substantial tax increases on persons with modest incomes even for a tax system that, in the abstract, seemed attractive. Of course, the severity of the transition problem for any particular flat tax proposal cannot be assessed according to any general principle; the only way is to make some necessary computations.

It is also important to understand the nature of such a winners-and-losers comparison. There is an almost universal agreement that the federal budget is far from balanced now and will be in near term. Therefore, it seems reasonable to assume that any tax proposal should at least equal the revenue yield of the current law. It then follows, regretably, that any changeover to a flat rate tax (or any other new tax system for that matter) is a "zero sum" game. For every dollar by which one taxpayer's liability is reduced, another taxpayer's liability must be increased by one dollar to keep the revenue total constant. (Some arguments that the flat tax reshuffling is not a zero sum transfer, and some caveats, will be discussed shortly.)

Analysis of Revenues and Distributional Effects of Four Flat Rate Taxes. With this background, Table 1 shows tax liabilities, by income class, for four different hypothetical flat rate tax systems. Each of these tax systems is designed to match the yield of the current tax law with 1984 rates at 1981 levels of income. The tax liabilities in each income group under these flat rate taxes can be compared with 1984 law liabilities (also included in the table) to see whether the tax burden is systematically shifted, and if so, where.

Systems 1 and 2 in the table are mainly illustrative to show the extreme outcomes under alternative tax bases. System 1 portrays a very broad tax base; long term capital gains are taxed in full, itemized deductions are prohibited, and the zero bracket amount and personal exemption are repealed. System 1 is thus a tax on gross income. In contrast, System 2 is simply a flat rate tax on the current law's rather narrow base. Predictably, the broad-based System 1 requires a much lower tax rate than the narrow-based System 2 (11.8 percent as opposed to 18.5 percent); but the distributional effects of the two systems are conspicuously similar. In both, the tax burden is significantly shifted from upper- to lower-income taxpayers; taxes are increased in the $15,000 - $20,000 group by about 30 percent, while taxpayers with incomes between $100,000 and $200,000 have their taxes cut by 40 to 50 percent. The only significant difference is at the extreme lower end of the income scale; System 1, without personal exemptions or standard deductions, hits the lowest-income taxpayers especially hard, though System 2 is not far behind on that score.

The major lessons of Systems 1 and 2 are probably that broadening the tax base is a prerequisite for achieving a low marginal tax rate (System 2's rate is almost 7 percentage points higher than System 1's) but also that greater rflief for low-income taxpayers is probably necessary to mitigate the redistributive effects of a flat rate tax. Systems 3 and 4 move on both of these fronts. Both of these systems maintain the broad income base of System 1, with capital gains taxed in full and no itemized deductions. System 3, however, permits the same personal exemption and zero bracket amount as under current law (a $1,000 exemption, and zero brackets of $2,300 for single people and $3,400 for married couples); System 4 increases the exemption and zero brackets even further (a $1,500 exemption, and zero brackets of $3,000 for single and $6,000 for joint returns). The tax rate under System 3 is 15.7 percent; System 4 requires an 18.7 percent rate.

Despite these changes, the results for Systems 3 and 4 show a general pattern similar to Systems 1 and 2. Again, the tax burden is shifted significantly, in these instances from the taxpayers with the highest incomes to those in the middle groups. Only the taxpayers with the lowest incomes are protected by the increased low-income relief in System 4. Under System 3, taxpayers in the $15,000 - $20,000 income group pay 19.0 percent more tax on average; those in the $100,000 - $200,000 group pay 33.2 percent less. Under System 4, the increase for the $15,000 - $20,000 group is 7.7 percent, while the $100,000 -$200,000 group gets a 23.1 percent tax cut.

Winners and Losers From the Redistributive Effects. The explanation of these redistributive effects and of their staying power in the face of adjustments to the flat tax system is relatively simple. Under 1984 law, taxpayers with six figure total incomes (that is, incomes of $100,000 and above, including long-term capital gains in full) will pay about 25 percent of their total incomes in tax. It follows, then, that any flat tax at a rate below 25 percent will cut taxes for those with incomes of $100,000 and up; for example, System 4 cuts their taxes by about one-fourth (25 percent minus 18.7 percent, divided by 25 percent).

If the flat tax is to maintain current law revenue yields, as System 4 does, then this revenue loss to those with the highest incomes must of necessity be made up by those with less income. The only way to moderate this effect in a flat rate tax is to increase the personal exemption and standard deduction. These steps reduce the tax liabilities of persons with the lowest incomes but require a higher tax rate, which adds further to the tax burden that the middle-income household must bear. Broadening the tax base more widely could help, but System 4 probably encompasses virtually all of the potential base broadening. Thus, under the flat tax, the average taxpayer is squeezed from both ends. The flat tax does not have the flexibility of a graduated tax, in which different tax rates can be raised and lowered in combination to ease the problems of creating winners and losers. It is also worth noting that the tax increases for middle-income groups shown in System 4 are averages; some taxpayers face increases greater than the average, and as noted above, among those with above-average tax increases will be typical homeowners.

Some arguments have been raised to suggest that the flat rate tax would be less redistributive than Table 1 suggests. One argument is that the flat tax rate need not yield the desired revenue at current levels of income, because the flat rate system would encourage substantial increases in work, saving, and investment, that taxable incomes would increase, and that tax revenues would thus exceed static estimates. (Therefore, the flat tax rate for System 4, for example, could be lower than 18.7 percent.) This is, of course, the supply-side argument so much in evidence during the consideration of the Economy Recovery Tax Act of 1981 (ERTA). However, even now, with the major supply-side provisions of ERTA in effect for many months (the Accelerated Cost Recovery System, or ACRS, since January 1981; the 20 percent maximum long-term capital gains tax rate since June 1981; and the 50 percent maximum tax rate on interest and dividends since January 1982), we are still trying to learn the precise magnitude of these supply-side effects. The uncertainty might be attributable to any number of extraneous factors, with high interest rates and a preordained cyclical downturn prominent among them. Given the obvious shortcomings of our understanding in these areas, it might be risky to count on supply-side effects to make up a revenue shortfall [illegible] a flat rate tax proposal.

Without a lower tax rate and the resulting static revenue loss, however, any flat rate tax proposal would increase the tax burden on middle-income households. No supply-side boost from upper-income taxpayers would remove this tax increase, and so the middle-income groups would still be worse off.

A second argument for a yield greater than conventionally estimated from a flat rate tax deals with the "underground economy" -- income that is earned but not reported to the IRS. This argument holds that current tax evaders would choose to report income earned under a flat rate tax, because the marginal tax rate would be lower, and the extra income from evading taxes would thus be reduced. The Treasury would therefore collect greater receipts, and so the flat tax rate could be lower than conventional analysis would suggest. This argument is more complicated than it sounds, and it must therefore be analyzed with care.

First, though everyone agrees that there is some underground economic activity, no one knows just how much. Estimates presented thus far have been based on extremely speculative methods, have yielded widely varying results, and have been highly controversial. Thus, it might be risky to embrace a tax policy on an assumption that some minimum amount of revenues from underground activity would be captured.

Second, the claim that the underground economy would surface if lower marginal tax rates were imposed is impossible to prove, and the compliance payoff of marginal tax rate reductions cannot be predicted accurately. One can only guess at the reactions of the unidentified and uncounted persons who take their income "off the books" if marginal tax rates were reduced. Today's participants in the underground economy are concealing their income from the IRS and getting away with it. They might elect to report their incomes if marginal tax rates were lower, because the payoff of tax evasion would be smaller. But if they are successful in evading tax now, and think that they can continue to do so without taking the legal consequences, why should they stop? Perhaps one can only raise the underground economy by persuading the tax evaders that they will be caught if they violate the law. That would require greater outlays for enforcement, not lower marginal tax rates.

Finally, however, it is not at all clear that underground tax evaders would receive marginal rate cuts under the flat rate tax. The marginal tax rate under System 4, for example, is almost 19 percent; a married couple with two children needs an adjusted gross income of $24,200 to exceed a 19 percent rate under 1984 law. But perhaps even more to the point is the total tax burden of middle-income households. As was shown in Table 1, even a flat rate tax with greater low-income relief would raise taxes, not lower them, for the broad middle group of households with incomes from $10,000 to $50,000. How will these taxpayers react to the tax increase? Rather than cause the underground economy to surface, the flat rate tax might drive currently law abiding middle income taxpayers underground and make the underground economy -- and the revenue loss -- bigger, not smaller.

Again, a flat rate proposal of current law yield without relying on revenues from the underground economy might nonetheless claim some of those revenues as a bonus. But still again, unanticipated revenues from the underground will not compensate the middle-income taxpayer for his flat tax increase.

Evaluation of the Fairness Issue. To sum up this discussion of fairness, the flat rate tax might, in the abstract, be preferred to a graduated system by a substantial share of the populace, though a recent poll suggests that the flat rate would fail to garner a majority of support. One problem of the flat rate tax, however, is its reshuffling of tax liabilities in comparison to current law. A flat rate tax would inevitably shift more of the tax burden to middle-income families — and possibly, depending on how it was constructed, to low-income families as well. If the flat rate tax were to equal the yield of the current tax law, then many middle-income taxpayers would face tax increases in the transition, while upper-income taxpayers enjoyed large tax cuts. Two arguments that a flat rate tax would yield more revenue than conventional analysis would suggest — supply-side effects and new revenues from the underground economy — are speculative, and might therefore be shakey grounds for long-range economic planning.

CONCLUSION

The proposals for broadening the tax base and charging a single tax rate have both benefits and costs. Broadening the tax base would result in a more efficient allocation of resources and lower tax rates. Some base broadening steps would simplify the tax code and forms to some extent, but others would complicate both;

the net balance is hard to predict. Finally, if deductions and exclusions were removed from the tax law and all forms of income were added to the tax base in the same way, many opportunities for tax gamesmanship might be cut off, and the public might have a higher opinion of the fairness of the income tax. There might be transition problems, however, for those who lost their tax preferences, and long-term problems if income were not properly measured.

The use of a single tax rate might have some positive effects but other, ill effects. A flat tax rate, if all else were equal, would raise the marginal tax rate for some taxpayers and lower it for others; whether the result is an efficiency gain or an efficiency loss is difficult to guage. The simplicity gains of a changeover would be minimal and superficial; taxpayers would continue to look up their tax liabilities on tax tables to minimize the likelihood of computation errors, and tax administration through high-speed computers would not be changed noticeably by the single tax rate.

In terms of equity, however, the effects of the single tax rate may be considerable. While, in the abstract, the flat rate may appeal to some people as more fair, in practice it would redistribute a significant share of the tax burden from upper-income to middle-income (and possibly even low-income) taxpayers. Many of these middle-income taxpayers already have limited financial flexibility due to contractual mortgage interest and property tax obligations.

After weighing these advantages and disadvantages of the typical flat rate tax package, the Congress might decide to accept or reject it. In the meantime, however, there is nothing to lose by considering the available options. The benefits of tax base broadening can be had through a measured approach, without necessarily repealing every deduction and exclusion. The tax rate schedule under a broad based system could be lower than it is now for most taxpayers without being completely flat. This general path has been suggested frequently by many tax analysts for many years.

The tax system is certainly not the only factor, and probably not even the most important factor, that fuels or drags the U.S. economy; but we should certainly do everything we can, using every possible method, to make it more efficient, simpler, and more fair.

1981 Tax Rate Schedules

Your zero bracket amount has been built into these Tax Rate Schedules.

Schedule X

Single Taxpayers

Use this schedule if you checked Filing Status Box 1 on Form 1040—

If the amount on Form 1040, line 34 is:		Enter on line 2 of the worksheet on this page:	
Over—	But not Over—		of the amount over—
$0	$2,300	—0—	
2,300	3,400	.... 14%	$2,300
3,400	4,400	$154+16%	3,400
4,400	6,500	314+18%	4,400
6,500	8,500	692+19%	6,500
8,500	10,800	1,072+21%	8,500
10,800	12,900	1,555+24%	10,800
12,900	15,000	2,059+26%	12,900
15,000	18,200	2,605+30%	15,000
18,200	23,500	3,565+34%	18,200
23,500	28,800	5,367+39%	23,500
28,800	34,100	7,434+44%	28,800
34,100	41,500	9,766+49%	34,100
41,500	55,300	13,392+55%	41,500
55,300	81,800	20,982+63%	55,300
81,800	108,300	37,677+68%	81,800
108,300	....	55,697+70%	108,300

Schedule Z

Unmarried Heads of Household

(including certain married persons who live apart (and abandoned spouses)—see page 6 of the Instructions)

Use this schedule if you checked Filing Status Box 4 on Form 1040—

If the amount on Form 1040, line 34 is:		Enter on line 2 of the worksheet on this page:	
Over—	But not over—		of the amount over—
$0	$2,300	—0—	
2,300	4,400	.... 14%	$2,300
4,400	6,500	$294+16%	4,400
6,500	8,700	630+18%	6,500
8,700	11,800	1,026+22%	8,700
11,800	15,000	1,708+24%	11,800
15,000	18,200	2,476+26%	15,000
18,200	23,500	3,308+31%	18,200
23,500	28,800	4,951+36%	23,500
28,800	34,100	6,859+42%	28,800
34,100	44,700	9,085+46%	34,100
44,700	60,600	13,961+54%	44,700
60,600	81,800	22,547+59%	60,600
81,800	108,300	35,055+63%	81,800
108,300	161,300	51,750+68%	108,300
161,300	....	87,790+70%	161,300

Schedule Y

Married Taxpayers and Qualifying Widows and Widowers

Married Filing Joint Returns and Qualifying Widows and Widowers

Use this schedule if you checked Filing Status Box 2 or 5 on Form 1040—

If the amount on Form 1040, line 34 is:		Enter on line 2 of the worksheet on this page:	
Over—	But not over—		of the amount over—
$0	$3,400	—0—	
3,400	5,500	.... 14%	$3,400
5,500	7,600	$294+16%	5,500
7,600	11,900	630+18%	7,600
11,900	16,000	1,404+21%	11,900
16,000	20,200	2,265+24%	16,000
20,200	24,600	3,273+28%	20,200
24,600	29,900	4,505+32%	24,600
29,900	35,200	6,201+37%	29,900
35,200	45,800	8,162+43%	35,200
45,800	60,000	12,720+49%	45,800
60,000	85,600	19,678+54%	60,000
85,600	109,400	33,502+59%	85,600
109,400	162,400	47,544+64%	109,400
162,400	215,400	81,464+68%	162,400
215,400	————	117,504+70%	215,400

Married Filing Separate Returns

Use this schedule if you checked Filing Status Box 3 on Form 1040—

If the amount on Form 1040, line 34 is:		Enter on line 2 of the worksheet on this page:	
Over—	But not over—		of the amount over—
$0	$1,700	—0—	
1,700	2,750	.... 14%	$1,700
2,750	3,800	$147.00+16%	2,750
3,800	5,950	315.00+18%	3,800
5,950	8,000	702.00+21%	5,950
8,000	10,100	1,132.50+24%	8,000
10,100	12,300	1,636.50+28%	10,100
12,300	14,950	2,252.50+32%	12,300
14,950	17,600	3,100.50+37%	14,950
17,600	22,900	4,081.00+43%	17,600
22,900	30,000	6,360.00+49%	22,900
30,000	42,800	9,839.00+54%	30,000
42,800	54,700	16,751.00+59%	42,800
54,700	81,200	23,772.00+64%	54,700
81,200	107,700	40,732.00+68%	81,200
107,700	....	58,752.00+70%	107,700

Caution

You must use the Tax Table instead of these Tax Rate Schedules if your taxable income is less than $50,000 unless you use Form 4726 (maximum tax), Schedule D (alternative tax), or Schedule G (income averaging), to figure your tax. In those cases, even if your taxable income is less than $50,000, use the rate schedules on this page to figure your tax.

Instructions

If you cannot use the Tax Table, figure your tax on the amount on line 34 of Form 1040 by using the appropriate Tax Rate Schedule. Then, unless you use Schedule G or Form 4726, figure your 1981 Rate Reduction Credit (1.25%) on the worksheet below.

Tax Computation Worksheet

(Do not use if you figure your tax on Schedule G or Form 4726.)

1. Taxable income from Form 1040, line 34 . ________
2. Tax on the amount on line 1 from Tax Rate Schedule X, Y, or Z . ________
3. Rate Reduction Credit. Multiply the amount on line 2 by .0125 . . . . . . ________
4. Subtract line 3 from line 2. Enter here and on Form 1040, line 35 . . . . ________

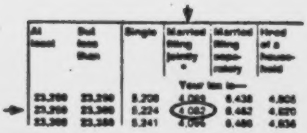
Do not file—keep for your records.

Note: *If you use the alternative tax computation on Schedule D (Form 1040), enter the amount from Schedule D, line 32, on line 1 of the worksheet. Complete the worksheet and enter the amount from line 4 of the worksheet on Schedule D, line 33.*

1981 Tax Table

Based on Taxable Income
For persons with taxable incomes of less than $50,000.

Example: Mr. and Mrs. Brown are filing a joint return. Their taxable income on line 34 is $23,270. First, they find the $23,250-23,300 income line. Next, they find the column for married filing jointly and read down the column. The amount shown where the income line and filing status column meet is $4,082. This is the tax amount they must write on line 35 of their return.



If line 34 (taxable income) is—		And you are—			
At least	But less than	Single	Married filing jointly *	Married filing separately	Head of a household
		Your tax is—			
0	1,700	0	0	0	0
1,700	1,725	0	0	[a]2	0
1,725	1,750	0	0	5	0
1,750	1,775	0	0	9	0
1,775	1,800	0	0	12	0
1,800	1,825	0	0	16	0
1,825	1,850	0	0	19	0
1,850	1,875	0	0	22	0
1,875	1,900	0	0	26	0
1,900	1,925	0	0	29	0
1,925	1,950	0	0	33	0
1,950	1,975	0	0	36	0
1,975	2,000	0	0	40	0
2,000					
2,000	2,025	0	0	43	0
2,025	2,050	0	0	47	0
2,050	2,075	0	0	50	0
2,075	2,100	0	0	54	0
2,100	2,125	0	0	57	0
2,125	2,150	0	0	60	0
2,150	2,175	0	0	64	0
2,175	2,200	0	0	67	0
2,200	2,225	0	0	71	0
2,225	2,250	0	0	74	0
2,250	2,275	0	0	78	0
2,275	2,300	0	0	81	0
2,300	2,325	[b]2	0	85	[b]2
2,325	2,350	5	0	88	5
2,350	2,375	9	0	92	9
2,375	2,400	12	0	95	12
2,400	2,425	16	0	99	16
2,425	2,450	19	0	102	19
2,450	2,475	22	0	105	22
2,475	2,500	26	0	109	26
2,500	2,525	29	0	112	29
2,525	2,550	33	0	116	33
2,550	2,575	36	0	119	36
2,575	2,600	40	0	123	40
2,600	2,625	43	0	126	43
2,625	2,650	47	0	130	47
2,650	2,675	50	0	133	50
2,675	2,700	54	0	137	54
2,700	2,725	57	0	140	57
2,725	2,750	60	0	143	60
2,750	2,775	64	0	147	64
2,775	2,800	67	0	151	67
2,800	2,825	71	0	155	71
2,825	2,850	74	0	159	74
2,850	2,875	78	0	163	78
2,875	2,900	81	0	167	81
2,900	2,925	85	0	171	85
2,925	2,950	88	0	175	88
2,950	2,975	92	0	179	92
2,975	3,000	95	0	183	95
3,000					
3,000	3,050	100	0	189	100
3,050	3,100	107	0	197	107
3,100	3,150	114	0	204	114
3,150	3,200	121	0	212	121
3,200	3,250	128	0	220	128
3,250	3,300	135	0	228	135
3,300	3,350	142	0	236	142
3,350	3,400	149	0	244	149
3,400	3,450	156	[c]3	252	156
3,450	3,500	164	10	260	162
3,500	3,550	172	17	268	169
3,550	3,600	180	24	276	176
3,600	3,650	188	31	283	183
3,650	3,700	196	38	291	190
3,700	3,750	203	45	299	197
3,750	3,800	211	52	307	204
3,800	3,850	219	59	316	211
3,850	3,900	227	66	324	218
3,900	3,950	235	73	333	225
3,950	4,000	243	79	342	232
4,000					
4,000	4,050	251	86	351	238
4,050	4,100	259	93	360	245
4,100	4,150	267	100	369	252
4,150	4,200	275	107	378	259
4,200	4,250	282	114	387	266
4,250	4,300	290	121	395	273
4,300	4,350	298	128	404	280
4,350	4,400	306	135	413	287
4,400	4,450	315	142	422	294
4,450	4,500	323	149	431	302
4,500	4,550	332	156	440	310
4,550	4,600	341	162	449	318
4,600	4,650	350	169	458	326
4,650	4,700	359	176	467	334
4,700	4,750	368	183	475	342
4,750	4,800	377	190	484	350
4,800	4,850	386	197	493	357
4,850	4,900	395	204	502	365
4,900	4,950	403	211	511	373
4,950	5,000	412	218	520	381
5,000					
5,000	5,050	421	225	529	389
5,050	5,100	430	232	538	397
5,100	5,150	439	238	547	405
5,150	5,200	448	245	555	413
5,200	5,250	457	252	564	421
5,250	5,300	466	259	573	429
5,300	5,350	474	266	582	436
5,350	5,400	483	273	591	444
5,400	5,450	492	280	600	452
5,450	5,500	501	287	609	460
5,500	5,550	510	294	618	468
5,550	5,600	519	302	627	476
5,600	5,650	528	310	635	484
5,650	5,700	537	318	644	492
5,700	5,750	546	326	653	500
5,750	5,800	554	334	662	508
5,800	5,850	563	342	671	515
5,850	5,900	572	350	680	523
5,900	5,950	581	357	689	531
5,950	6,000	590	365	698	539
6,000					
6,000	6,050	599	373	709	547
6,050	6,100	608	381	719	555
6,100	6,150	617	389	730	563
6,150	6,200	626	397	740	571
6,200	6,250	634	405	750	579
6,250	6,300	643	413	761	587
6,300	6,350	652	421	771	594
6,350	6,400	661	429	781	602
6,400	6,450	670	436	792	610
6,450	6,500	679	444	802	618
6,500	6,550	688	452	812	627
6,550	6,600	697	460	823	635
6,600	6,650	707	468	833	644
6,650	6,700	716	476	844	653
6,700	6,750	726	484	854	662
6,750	6,800	735	492	864	671
6,800	6,850	744	500	875	680
6,850	6,900	754	508	885	689
6,900	6,950	763	515	895	698
6,950	7,000	772	523	906	707
7,000					
7,000	7,050	782	531	916	715
7,050	7,100	791	539	927	724
7,100	7,150	801	547	937	733
7,150	7,200	810	555	947	742
7,200	7,250	819	563	958	751
7,250	7,300	829	571	968	760
7,300	7,350	838	579	978	769
7,350	7,400	848	587	989	778
7,400	7,450	857	594	999	787
7,450	7,500	866	602	1,009	795
7,500	7,550	876	610	1,020	804
7,550	7,600	885	618	1,030	813
7,600	7,650	894	627	1,041	822
7,650	7,700	904	635	1,051	831
7,700	7,750	913	644	1,061	840
7,750	7,800	923	653	1,072	849
7,800	7,850	932	662	1,082	858
7,850	7,900	941	671	1,092	867
7,900	7,950	951	680	1,103	875
7,950	8,000	960	689	1,113	884

*This column must also be used by a qualifying widow(er).

Continued on next page

[a] If your taxable income is exactly $1,700, your tax is zero.
[b] If your taxable income is exactly $2,300, your tax is zero.
[c] If your taxable income is exactly $3,400, your tax is zero.

The Harris Survey

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MAJORITY OF AMERICANS REJECT PROPOSAL TO ABANDON GRADUATED INCOME TAX

By Louis Harris

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The recent proposals by some supply-side economists that the country ought to abandon the graduated income tax for a system under which everyone pays a 20 percent federal income tax meets with a resounding rejection by 61-34 percent of Americans.

The main argument by advocates for repeal of the graduated income tax is that "people with higher incomes are the ones who invest in the economy and make it grow, so they need a break like this to stimulate investment and growth." This is the same claim that was made during the debate on an across-the-board tax cut that was finally passed by Congress in July.

However, a 56-39 percent majority of Americans does not go along with this argument, according to the latest Harris Survey conducted between Aug. 11 and Aug. 16 among a cross section of 1,248 adults nationwide. If higher-income people are to be induced to invest more of their funds, most Americans would prefer that some means other than a change in the concept of the graduated income tax be devised. All groups below the $35,000 income level want to retain the progressive tax system under which the higher a person's income, the higher the percentage of federal income tax the individual will pay. The country has had that system for 68 years, ever since the Constitution was amended to permit the federal government to levy a federal income tax.

Among those with annual incomes of more than $35,000, however, a 49-47 percent plurality goes along with the argument that by going to a 20 percent across-the-board tax, investment will be stimulated. Supply-siders no doubt would argue that this is proof positive that such a change in the tax system would indeed set loose a new flood of investment money. However, the rest of the public clearly doesn't see it that way. Instead, they seem to be convinced that having those with the highest incomes pay the same tax rate as those with lower incomes is a windfall benefiting those who are most in a position to pay higher taxes.

In fact, a 53-39 percent majority feels that "to charge everyone the same percentage of their income in taxes would be decreasing federal income taxes for the rich and increasing taxes for people with incomes below $18,000 a year." Even those in the over-$35,000 income bracket agree, by 57-36 percent, that this would be the case.

This latest trial balloon on repealing the graduated income tax is one of a growing number of measures put forth by supply-side economic advocates. People now expect that one of the singular marks of the Reagan years in the White House will be harder times for the less privileged and a field day for the most privileged. When asked to estimate what things would be like a year from now, a 75-21 percent majority of Americans is convinced that "the rich and big business will be much better off" and a 64-32 percent majority feels "the elderly, the poor and the handicapped will be especially hard hit."

If a major effort is mounted to repeal the graduated income tax, it will mean undertaking the considerable task of reversing the opinion of a sizable majority of the American people. Not only does a 61-34 percent majority oppose a 20 percent across-the-board personal income tax, but also, by 58-38 percent, a majority feels that the current progressive income tax, based on the principle that "higher-income people not only have to pay more in taxes, but must pay a greater percentage of their income in taxes," is "fair and equitable."

At a time when taxes clearly are not popular, to have a 20-point majority that feels the federal income tax is fair and equitable is a real measure of the job facing those who would attempt to change the system. Significantly, a 60-37 percent majority of the college-educated defends the current tax principle, as does a 67-30 percent of professional people. However, among business executives, only a 51-46 percent majority shares this view, as does a 53-45 percent majority of those in the highest income brackets.

These latest results show that political conservatives have not yet reached the point where they are ready to change the graduated income tax. By 57-38 percent, a majority would oppose a 20 percent across-the-board federal income tax. And a 55-41 percent majority of conservatives feels the current federal tax system is "fair and equitable."

TABLES

Between August 11th and 16th, the Harris Survey asked a cross section of 1,248 adults nationwide by telephone:

"For the past 69 years, the federal income tax has been based on the principle that higher-income people not only have to pay more in taxes but must pay a greater percentage of their income in taxes. Do you feel that principle is fair and equitable or not?"

GRADUATED INCOME TAX FAIR?

	Fair and equitable %	Not fair and equitable %	Not sure %
Total	58	38	4
8th grade education	50	31	19
High school	57	39	4
College	60	37	3
$7,500 or less	59	36	5
$7,501-15,000	56	37	7
$15,001-25,000	63	34	3
$25,001-35,000	61	38	1
$35,001 and over	53	45	2
Professional	67	30	3
Executive	51	46	3
Proprietor	54	44	2
Skilled labor	60	39	1
White collar	56	41	3
Conservative	55	41	4
Middle of the road	62	35	3
Liberal	55	41	4

"Now it is being proposed that instead of the system of higher-income people paying a greater percentage in federal income taxes, everyone would pay the some percentage of their income in taxes, such as 20% for everyone. Would you favor having everyone pay the same percentage of their income in taxes, or would you favor keeping the present system, under which higher-income people pay a greater percentage in taxes?"

EVERYONE PAY SAME PERCENTAGE OF INCOME TAX?

	Favor everyone paying same percentage %	Favor keeping present system %	Not Sure %
Total	34	61	5
8th grade education	29	50	21
High school	32	64	4
College	38	57	5
$7,500 or less	19	70	11
$7,501-15,000	32	65	3
$15,001-25,000	35	61	4
$25,001-35,000	38	56	6
$35,001 and over	48	49	3

EVERYONE PAY SAME PERCENTAGE OF INCOME TAX? (CONT'D)

	Favor everyone paying same percentage %	Favor keeping present system %	Not sure %
Professional	37	57	6
Executive	39	59	2
Proprietor	44	54	2
Skilled labor	38	59	3
White collar	31	62	7
Conservative	38	57	5
Middle of the road	35	61	4
Liberal	29	66	5

"Now let me read you some statements about changing the federal income tax system so that every person pays the same 20% of their income in taxes. For each, tell me if you agree or disagree."

STATEMENTS ON CHANGING FEDERAL INCOME TAX SYSTEM

	Agree %	Disagree %	Not sure %
To charge everyone the same percentage of their income in taxes would be decreasing federal income taxes for the rich and increasing taxes for people with incomes below $18,000 a year	53	39	8
People with higher incomes are the ones who invest in the economy and make it grow, so they need a break like this to stimulate investment and growth	39	56	5

METHODOLOGY

This Harris Survey was conducted by telephone with a representative nationwide cross section of adults 18 and over at 1,248 different sampling points within the United States between August 11th and 16th. Figures for age, sex and race were weighted where necessary to bring them into line with their actual proportions in the population.

In a sample of this size, one can say with 95% certainty that the results are within plus or minus 3 percentage points of what they would be if the entire adult population had been polled.

This statement conforms to the principles of disclosure of the National Council on Public Polls.

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TABLE 1. DISTRIBUTION OF TAX LIABILITIES UNDER ALTERNATIVE FLAT RATE TAX SYSTEMS COMPARED TO 1984 TAX LAW[a] AT 1981 INCOME LEVELS

			System 1			System 2			System 3			System 4		
			(11.8 percent tax on adjusted gross income with long-term capital gains included in full)			(19.5 percent tax on 1984 law taxable income less zero bracket amount)			(15.7 percent tax on 1984 law taxable income less zero bracket amount, with long-term capital gains included in full, and no itemized deductions)			(18.7 percent tax on taxable income as in System 3 with $1,500 personal exemption and $3,000 ($6,000) zero bracket amount for single (joint) returns)		
Expanded Income (thousands)	Number of Taxable Returns (thousands)	Tax Liability 1984 Law (millions)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Liability (millions)	Change (Percent)	Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)	Tax Liability (millions)	Change (Percent)	Change (Dollars Per Return)
< 5	6,482	403	5,479	1,259.5	783.07	1,574	290.7	180.71	2,232	453.7	282.10	1,996	395.2	245.71
5- 10	15,057	5,772	14,280	147.4	565.04	8,752	51.6	197.91	7,854	36.1	138.26	5,345	-7.4	-28.33
10- 15	13,092	12,526	19,700	57.3	547.99	17,610	40.6	388.31	15,720	25.5	243.97	12,698	1.4	13.11
15- 20	10,737	17,462	22,496	28.8	468.88	22,665	30.0	484.54	20,778	19.0	308.88	18,802	7.7	124.76
20- 30	16,800	44,080	49,701	12.8	334.58	52,871	19.9	523.28	49,978	13.4	351.06	48,170	9.3	243.45
30- 50	13,568	63,833	60,579	-5.1	-239.82	66,419	4.1	190.61	66,466	4.1	194.08	68,804	7.8	366.41
50-100	3,580	38,687	27,389	-29.2	-3,155.74	30,486	-21.2	-2,290.90	32,658	-15.6	-1,684.20	36,104	-6.7	-721.60
100-200	631	18,656	9,872	-47.1	-13,920.58	10,743	-42.4	-12,540.20	12,459	-33.2	-9,821.59	14,344	-23.1	-6,833.56
200 <	164	16,385	7,675	-53.2	-53,107.15	7,129	-56.5	-56,438.05	10,050	-38.7	-38,630.67	11,843	-27.7	-27,692.33
Total	80,110	217,803	217,172	-0.3	-7.87	218,249	0.2	5.57	218,194	0.2	4.88	218,106	0.1	,3.78

SOURCE: Joint Committee on Taxation.

a. To facilitate comparison, 1984 law does not include the earned income credit, the two-earner couple deduction, or the IRA or Keogh provisions. The flat rate tax systems similarly do not include those provisions.

b. Outcomes under the flat-rate tax for tax returns of under $5,000 of income would be highly uncertain. Some taxpayers at that income level currently make use of tax preferences that would be terminated under the flat-rate tax, and those taxpayers would thus face substantial tax increases. A particular problem would arise under System 1, in which all income would be subject to tax without exemption or deduction; many households with very low incomes who are excused from filing tax returns under the 1984 law are therefore not represented in the table, but would have to file returns and pay taxes under System 1. The impact of this factor on the table would likely be small, though it would significantly change administrative burdens under the tax system.

From: People & Taxes. Volume XII, NO. 5. June 1984

Tax Income, Not Consumption

BY JOSEPH J. MINARIK

The huge federal budget deficits will require a tax increase above and beyond the "down payment" Congress is currently devising. Today's tax system, however, is too riddled with inequities and inefficiencies to bear the additional burden. So policy-makers are considering broadscale alternatives for 1985, including a thoroughly revamped income tax and assorted consumption taxes.

Widely discussed consumption tax proposals include taxes on transactions, such as a national sales tax (NST) or value-added tax (VAT), or a tax on households such as a personal expenditure tax (PET). The rationale for taxing consumption is that our nation consumes too much, and that taxing consumption would encourage more saving and capital formation. Adopting any consumption tax would significantly change our current system, which primarily taxes income.

National Sales Tax

Any American who buys books, furniture, or detergent is probably familiar with consumption taxes on transactions. One version, the NST, would apply to sales at the retail level, just like state sales taxes.

A VAT (the identical twin of the NST in economic terms, depending on some technical details) would apply to all sales from the beginning of the chain of production through the final retail sale. The NST therefore would require less paperwork. Either measure would be tacked on to the current system, rather than replacing any existing tax in toto.

There are numerous problems with an NST (or a VAT). An NST would be regressive, because it would tax most heavily those who consume most of their incomes — low-income people. The familiar proposal to exempt food, housing, and medical care would not reduce this burden. Apart from the poorest of the poor, most households spend roughly the same share of their budgets on these items.

Another proposal to reduce regressivity is a refundable income tax credit. This credit would be complex and at least partially ineffective, however. Low-income taxpayers who now are not required to file tax returns would have to file to claim their tax credits, complicating life for them and the IRS. Further, low-income households would have to pay the NST or VAT all year and then wait for a refund, barring an even more complicated scheme to distribute the refunds throughout the year.

An NST or VAT would immediately increase retail prices, and thus push up inflation. Also, it could interfere with state tax collections, since the sales tax is an important revenue source for many states.

A recently publicized alternative is a so-called tax on business transactions, backed by lobbyist Charls E. Walker. The TBT is like a VAT but would not tax the final retail sale, and thus would not tread directly on the state sales tax source. But by exempting the retail sale from tax, the TBT would favor significantly businesses that do their own retail selling, like Radio Shack, relative to those businesses that sell to independent dealers, like Apple Computer.

Finally, the NST or VAT is not a simple tax, and would involve considerable collection overhead. The experience of Great Britain, which relies heavily on a VAT, suggests that a VAT costs as much to collect as an income tax.

Personal Expenditure Tax

The newcomer to the scene, the personal expenditure tax, is not nearly as well known. Unlike the NST or VAT, the PET would be collected like the individual income tax, from each household on an annual basis. Most tax would be withheld from wages, just as it is now.

The major difference between a PET and the current income tax is that expenditure-tax payers could deduct all money they saved and would have to pay tax on all money they borrowed or withdrew from their saving. In this way, the PET would discourage consumption and borrowing, and encourage saving — at least in theory.

In fact, the PET would make income from capital effectively tax-exempt. If a taxpayer reduces his consumption to save more, the federal government in effect matches his saving with a tax reduction through the deduction for saving.

Suppose a taxpayer in the 50 percent bracket reduces his consumption by $1,000. His tax goes down enough for him to put $2,000 in his own bank account. The higher the tax rate, the larger this government matching grant.

If the taxpayer later withdraws and spends the money he saved, the federal government merely recoups its earlier matching grant, with interest. There is no net tax at all.

So in this example, if the taxpayer withdraws his $2,000 plus 10 percent interest one year later, he can consume $1,100, or his $1,000 of postponed consumption, plus interest. The federal government only gets its earlier $1,000 matching grant plus its share of the interest.

So the PET is really a wage tax, because it effectively exempts all income from property, thus only taxing labor. No matter how steep the PET's tax rate schedule, it favors those who have wealth over those who don't.

But would a PET really increase saving? The very large Kemp-Roth tax rate cuts, which were supposed to spur saving, provide a clue. While it is too early to draw any final conclusions, the savings rate has not risen since Kemp-Roth was enacted in 1981.

Proponents of the PET claim it will simplify the tax law, because businesses can immediately deduct the cost of capital investments. Under the current tax law, a business must keep records and deduct part of the cost of a machine or building each year over a period of several years.

CATHERINE GALE

Simplicity Exaggerated

But this simplicity advantage is easily exaggerated. Few taxpayers ever use tax depreciation, and many of those who do would need accountants to keep track of their business affairs with or without depreciation accounting. And this simplicity is attained only by completely exempting capital income from tax, as the example above illustrates.

On the other hand, every taxpayer, regardless of his financial sophistication, would need to keep track of and report his saving and borrowing under an expenditure tax. So this additional compliance burden would bear on all taxpayers, particularly low-income people.

The fairness of the expenditure tax is questionable not just because it effectively exempts income from capital. The deduction for saving would reduce taxes for people with income in excess of their needs — mostly for those in their prime earning years. The PET would bear relatively more heavily on the young, who borrow to set up their households; on the old, who draw down their savings to finance their retirement; and on those who borrow or draw down their savings because their incomes are temporarily reduced by unemployment or illness.

The VAT is not a simple tax, and would involve considerable collection overhead. The experience of Great Britain, which relies heavily on a VAT, suggests that a VAT costs as much to collect as an income tax.

The expenditure tax would also tend to maintain tax revenues when the economy is weak, because the borrowing and withdrawals from savings of those down on their luck would be taxable. The PET's revenues would also increase more slowly when the economy was strong, because saving would be deductible. This is precisely the wrong pattern for maintaining stable growth.

Taxation of the elderly raises another serious logistical and fairness problem of the PET. Consider a retiree who paid income tax all his life and saved in the form of stocks or bonds. This retiree would have to pay tax all over again after enactment of an expenditure tax when he withdrew his savings to finance his retirement.

Preventing such double taxation would require an elaborate deduction mechanism for all holders of previously taxed wealth. But other persons who saved in untaxed forms such as IRAs, Keoghs, employer pension contributions, or previously untaxed capital gains should properly be taxed when they consume their wealth.

Sorting each taxpayer's taxed wealth from his untaxed wealth, and providing appropriate deductions, would be a necessary but monumental task of transition to an expenditure tax. Proposals for "rule of thumb" transitions, with some arbitrary, fixed deduction for all taxpayers above a certain age, would capriciously distribute billions of dollars of tax relief among millions of taxpayers, whether they actually saved in taxable forms or not.

Think Twice

So it is far from clear whether we could enact a PET that would do its intended job. The PET might increase capital formation slightly, but it would involve complex transition rules and make the system less fair.

No one is happy with the income tax system. But we could reform the system (as Senator Bill Bradley and Representative Richard Gephardt propose, for example) far more easily than we could replace it. A restructured income tax would be progressive, and it would be easier for taxpayers to understand.

Taxes on consumption may have reached the fad stage. But before our nation buys one, we had best think twice. ■

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TAX ANALYSTS SPECIAL REPORT

INCOME VERSUS EXPENDITURE TAXATION TO REDUCE THE DEFICIT

by Joseph J. Minarik

Joseph J. Minarik, a senior research associate at the Urban Institute, presented this article as a paper at the Annual Meetings of the Southern Economics Association in Washington, D.C. on November 21, 1983. In the article, Minarik compares income and expenditure taxes as alternative means of reducing the federal deficit. He also examines hybrid taxes, such as our current income tax, which combine elements of both income and expenditure taxes. Minarik concludes that most of the arguments in favor of an expenditure tax are narrowly focused and that a broader perspective makes the income tax more attractive. For example, he says that it is not enough to argue for an expenditure tax on grounds that it will encourage capital investment; one must also consider what effect an expenditure tax would have on supply of labor. He also concludes that an expenditure tax would sacrifice fairness to economic efficiency and that the transition to an expenditure tax would be extremely difficult.

The views in this article should not be attributed to the Urban Institute.

A vigorous debate has raged recently over the choice between income and expenditure taxation in our current budgetary stringency. This article takes the side of the income tax. Of course, taking sides in any such debate requires a certain reserve of idealism. I'm sure that even its best friends could easily imagine an expenditure tax so poorly designed that they would prefer an income tax. I needn't add that the current income tax has a face that only a mother could love.

Nonetheless, our recent history leaves us with hope, if not idealism. Concern over the state of the tax system mounts so high that it may yet motivate action. Included in that concern is both a popular perception that the tax system is unfair, and a belief held by many economists and businessmen that the tax system slows economic growth. There seems little doubt that a serious attempt at tax restructuring could leave both the populace (or at least a majority thereof) and its economic sages (with the same qualification) much happier.

That leaves the choice between income and expenditure taxation. Of course, there are really more than two elements in this choice set; there is a continuum of stops along the route from the income tax to the expenditure tax, and in fact, the policy process has been finding ever more scenic unmapped byways for several years now. Therefore, this article will cover not only the choice between the two extremes of the income-expenditure tax highway, but also the direction in which we should travel if the end of the line is not our chosen destination.

Because the income tax is a known quantity, this article will proceed by asking a number of questions about the expenditure tax as an alternative. The questions will relate not only to the choice between the two taxes in the abstract, but also to the unavoidable costs of transition from the income tax to the expenditure tax in our mature economy. If there is any recurring theme to this paper, it is that the arguments for the expenditure tax tend to be extremely narrow in focus; and that a broader view, embracing more of the relevant criteria of a desirable tax system, lends far less support to the expenditure tax.

A Zero Tax Rate for Income from Capital?

The current sentiment of much of the economics profession seems to be that the appropriate rate of tax on income from capital is zero, because a zero rate of tax allegedly will yield the most saving and investment. Therefore, the sentiment goes, the appropriate tax on individuals and households is an expenditure tax.

Surely, the hallmark of the expenditure tax is its effective exemption from taxation of income from capital.[1] While other selling points are sometimes raised, by far the major argument for the expenditure tax has been the alleged increase in capital formation that would result from that tax exemption. The merits of this argument will be assessed presently. But an argument solely focused on the capital formation issue is incomplete; there are more criteria for a good tax system than just the promotion of physical investment.

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[1] If a taxpayer invests $1, he receives an immediate tax deduction for that act of saving, and so his net of tax investment is only $(1-t) (where t is the tax rate). (So, for example, a taxpayer in the 40 percent tax bracket would have his taxes immediately reduced by 40 cents; the after-tax cost to him of making the $1 investment would thus be 60 cents.) If the investment returns a pretax profit of $r, the investor keeps $r(1-t) net of tax, making his after-tax rate of profit r—the same as the pretax rate. (Continuing the example, if the investment returned 10 percent in one year and the taxpayer then sold it and consumed the proceeds, he would pay 44 cents in tax and could consume 66 cents. Thus, after taxes, the investor would earn six cents interest on his 60 cent after-tax investment; that is a 10 percent after-tax return, the same rate as the before-tax return. The investment is therefore effectively tax-exempt.) Obviously, this generalization depends crucially on the investor's having other taxable consumption against which to deduct his initial investment, and the equality of the tax rate against which the investment is deducted and that at which the return is taxed.

How much difference does it make? Before proceeding any further, it is worth asking what we can expect from the expenditure tax in terms of increased capital formation. The responsiveness of savings rates to the real after-tax rate of return has been the subject of heated debate in recent years.[2] The debate arises, of course, because the effect of the rate of return on savings is theoretically ambiguous due to contrary income and substitution effects. Since its early beginnings in empirical measurement, the debate has uncovered ever larger estimates of the responsiveness of saving to rates to return.[3] Despite the research developments, the debate remains unresolved; partisans on both sides refuse to give ground.

It is unclear to what degree the expenditure tax would increase capital formation, whether it would impose offsetting costs of labor, and whether it would meet with popular acceptance as fair.

As a personal opinion, the richness of the saving choice, with its questions of taxpayers' time horizons, saving motives, and possible ultrarationality with respect to government or corporate behavior, is such that the question must remain fundamentally empirical. And in this regard, the experience of the last two years may ultimately be instructive. On at least four counts, individual taxpayers should have increased their savings sharply, including the alleged responsiveness to the rate of return: tax rates were significantly reduced, and a tax-free savings vehicle (the individual retirement account, or IRA) was expanded to include virtually all taxpayers; inflation fell, leaving real rates of return at historically high levels; real growth dropped, giving taxpayers their usual cyclical saving motive; and projected federal deficits shot up for the foreseeable future, giving any ultrarational savers a clear signal to prepare to take on a burgeoning national debt service burden.

To date, and admittedly with only early data available, there are no signs of a significant response on the part of savers. Of course, formal empiricism must wait at least until the data are final, and observations such as these are now little more than speculation. But there would seem to be a rightful burden on those who propose to push our recent semi-controlled experiment to stage two to show at least some evidence of success in stage one.

What would happen to marginal tax rates? An expenditure tax would require higher and steeper marginal tax rates than an income tax (with an otherwise equivalent tax base) to attain the same total yield and distribution of the tax burden. The tax rates must be higher because the tax base is narrowed by the exclusion of saving. (Other questions regarding the expenditure tax base will be addressed shortly.) The tax rate schedule must be steeper because upper-income taxpayers save a greater proportion of their income, at least according to the limited data now available.

The effect of these higher and steeper tax rates on labor supply is less than obvious. There are predictable effects in terms of the relative attractiveness of market and unpaid nonmarket work, and of cash and (if untaxed) noncash compensation. But depending on a taxpayer's time horizon, labor income that is expected to be spent in the foreseeable future could become less attractive if marginal tax rates rise in an expenditure tax. (The same, in fact, could apply to saving for foreseeable future consumption.) If the expenditure tax is to be deemed more attractive because it reduces the tax burden on capital, there should at least be some recognition of the inevitable effect on labor.

Does the populace want a tax exemption for capital income? At least by anecdotal evidence, much of the popular motivation for major revision or replacement of the income tax comes from a perception of unfairness. And this perception, by many accounts, arises from a sense that those who have the necessary wealth and expertise can shelter their income from tax, while others who cannot afford the carefully couched investments and the advice must pay at the statutory rates.

Does it address this concern to give a tax deduction to all acts of saving, rather than requiring the intervention of a tax shelter broker? Would the public response to the expenditure tax be any more affectionate than what we face now?

Surely, the hallmark of the expenditure tax is its effective exemption from taxation of income from capital.

An expenditure tax advocate can dispute this description of the public complaint about the current tax law, which is admittedly an impression from polls and news accounts. It can be argued that the public does not appreciate the economic importance of greater capital formation and the policies needed to achieve it; and that education on this issue will bring opinion around. But fairness is a value too, a value worth paying for; and fairness is what the people think it is. We must recognize the possibility, if not the certainty, that an expenditure tax would violate the popular perception of what the tax system should be.

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[2] An early study is Colin Wright, "Saving and the Rate of Interest," in Arnold C. Harberger and Martin J. Bailey, editors, *The Taxation of Income from Capital* (Brookings, 1969), pp. 275-300. The more recent debate began with Michael J. Boskin, "Taxation, Saving, and the Rate of Interest," *Journal of Political Economy*, vol. 86 (April 1978), part 2, pp. S3-S27; and E. Philip Howrey and Saul H. Hymans, "The Measurement and Determination of Loanable-Funds Savings," *Brookings Papers on Economic Activity, 3:1978*, pp. 655-706.

[3] Michael J. Boskin and Lawrence J. Lau, "Taxation and Aggregate Factor Supply: Preliminary Estimates," in U.S. Department of the Treasury, *1978 Compendium of Tax Research*, pp. 3-15; Lawrence H. Summers, "Capital Taxation and Accumulation in a Life Cycle Growth Model," *American Economic Review*, vol. 71 (September 1981), pp. 533-544.

In short, it is unclear to what degree the expenditure tax would increase capital formation, whether it would impose offsetting costs on labor, and whether it would meet with popular acceptance as fair.

Should We Tax Wealth Or Bequests More Heavily?

An expenditure tax would allow taxpayers to earn interest on their wealth without tax until the wealth was finally consumed. If that wealth was passed on to a succeeding generation, however, it would not bear expenditure tax unless the gift or bequest was treated as consumption. Some economists who favor the expenditure tax suggest taxation of gifts and bequests as consumption of the donor; others, of the donee. Still others argue that the current estate and gift tax, if strengthened, could fulfill this function, or that a periodic wealth tax would be preferable. And yet a final group would oppose any taxation of gifts or bequests as contrary to the capital formation motive of the expenditure tax.

Some economists who favor the expenditure tax suggest taxation of gifts and bequests as consumption of the donor; others of the donee. Still others argue that the current estate and gift tax...could fulfill this function....

We know very little about the effect of estate and gift taxation on the incentive to save, and less about the potential effect of expenditure taxation of gifts and bequests. We do know that the choice in this area would have a crucial effect on the ultimate distribution of income and wealth, and upon the popular acceptability of the tax. The taxation of wealth has been an extraordinarily controversial area, with the Congress fluctuating from the carryover of basis at death, on the one hand, to sharp increases in the unified credit and large cuts in the maximum estate and gift tax rate, on the other. It is fair to say that for many economists this apparently minor provision, whose ultimate disposition would be quite uncertain, could make the difference between an acceptable or an unacceptable expenditure tax.

What Is The Expenditure Tax Base?

Would we continue current law deductions? There would probably be no "standard deduction" for savings under an expenditure tax, because such a deduction would eliminate below a point the marginal incentive for saving (or against net borrowing). However, there is a question about the deductions we now have under the income tax. Some would advocate continued deductibility of state and local taxes, medical expenses, or charitable contributions under the expenditure tax. (Indeed, some would advocate more than a deduction for charitable contributions; with only a deduction, a giver gets no tax advantage over putting the money in the bank for himself.) If these deductions are retained there would have to be a standard deduction, or else all taxpayers (instead of the one-third currently) would have to itemize their deductions. The latter method would be clearly undesirable for the many taxpayers who would have difficulty with this recordkeeping and computational burden, and for the IRS. Even if a standard deduction is made available, however, each taxpayer will have to deal with personal exemptions, a standard deduction or itemized deductions, and a deduction for saving (or taxability of borrowing).

Under current law, a taxpayer with only wage income and no itemized deductions can clip his W-2 form to his tax return and look up his tax liability with essentially no computation. (Indeed, the IRS will compute the tax of such a taxpayer.) Under the expenditure tax, with the deductibility of saving and the taxation of borrowing, such an individual's tax filing procedure could be substantially more complicated.

How broad would the expenditure tax base be? The expenditure tax is alleged to have a broader base than the current income tax, and it certainly could. But the breadth of the expenditure tax base in practice is by no means certain. It was already suggested that the current law deduction for medical expenses could be extended to the expenditure tax, and one might even wonder if that deduction could be broadened; it is hard to imagine the extension of a value-added tax or a sales tax to medical expenses. There would be other candidates for preferred treatment. Charitable contributions have already been nominated here. Educational expenses could be suggested on social grounds, and also as savings in the form of human capital. Work-related expenses would appear as well. In short, the expenditure tax could be the victim of the same and new pressures for special tax relief as the income tax.

How would housing and other consumer durables be treated? In one sense, the opportunity to eliminate the tax preference for owner-occupied housing is one of the major attractions of the expenditure tax; the tax treatment of investments in different forms could be made more neutral. But from a more realistic point of view, eliminating the tax advantage of housing is probably impossible politically. It may not even be desirable, given the enormous transition costs to recent homebuyers; and grandfathering current owners could be enormously complex. We must ask whether the transition to the expenditure tax without the benefit of the housing "twist" would be worthwhile.

The responsiveness of savings rates to the real after-tax rate of return has been the subject of heated debate...the debate remains unresolved....

If housing retains favorable tax treatment in some form, other durables might also. The transition to the expenditure tax could be another opportunity to obtain tax preferences for purchases of domestic automobiles, for example.

In short, the base of an expenditure tax could well be smaller than its potential, and could involve significantly greater complexity for many taxpayers.

What Is Saving?

Saving is an unambiguous concept in theory, but it is much more slippery in practice. It certainly includes purchases of stocks and bonds, and deposits in savings accounts. But how about purchases of antiques or "investment" rugs? What about gold and other precious metals? Or other commodities, either as pure speculation or hedging for business purposes? Or physical additions to the taxpayer's home?

There must be a definition of saving for expenditure tax administration. Unfortunately, that definition can be contentious and complex. The line that is finally drawn will compromise between interference with taxpayer choice, and dissipation of capital formation in unproductive assets.

Do We Want Ex Ante Neutrality?

An attractive property of the expenditure tax, according to its advocates, is that it taxes equally (in present value terms) persons with equal lifetime income streams. The notion is that people who defer more of their consumption, and therefore earn more interest, are able to consume more and pay more taxes in absolute terms; but discounting by that same rate of interest makes lifetime taxes equal. Of course, this property rests on several assumptions that are unlikely ever to be realized: there must be no prior wealth from gifts or bequests; rates of return must be equal; a single rate of tax must not change over the taxpayers' lifetimes; and all of income ultimately must be consumed, with no gifts or bequests to succeeding generations (or alternatively, gifts and bequests must be considered as consumption to the donor).

Given the unlikelihood of compliance with these assumptions, some analysts fall back on a more general interpretation of lifetime outcomes under the expenditure tax. While incomes may fluctuate from year to year, taxpayers attempt to smooth their consumption streams to maintain a more constant standard of living. By this interpretation, consumption is a better indicator of lifetime or permanent income than is annual income, and lifetime income is the preferable tax base.

But lifetime income can be challenged as the best base for income taxation. For one thing, lifetime income is imperfectly measured by taxpayers in their current consumption. Taxpayers have only the vaguest knowledge of their future incomes in most instances, and changes in national affairs far beyond taxpayers' control can render their expectations obsolete overnight. In a volatile economy so devoid of certainty, current consumption is a most questionable proxy for income as a tax base.

An expenditure tax would require higher and steeper marginal tax rates . . . to attain the same total yield and distribution of the tax burden.

Further, we may not want a tax base that is a smoothed approximation of lifetime income. The typical lifetime profile of income and expenditure involves borrowing to aid in early household formation, saving in the later peak earning years, and then dissaving upon retirement. The expenditure tax, relative to the income tax, would burden taxpayers more heavily in their early and later years of greatest need, and less in their middle years of greatest prosperity.

Another questionable property of the expenditure tax would be its treatment of unforeseen and adverse events. A taxpayer whose income falls because of illness, unemployment, or any other uncontrollable factor will typically borrow or dissave to maintain an approximation of his standard of living. Such a taxpayer would be hit relatively harder by an expenditure tax than an income tax. To an expenditure tax advocate, this is a desirable form of tax averaging; by another view, however, it is an unnecessary and painful burden.

The expenditure tax could be the victim of the same and new pressures for special tax relief as the income tax.

To sum up, the expenditure tax has unique theoretical properties with respect to lifetime consumption and income, but those properties are questionable advantages at best in practice.

What Do We Do About The Corporate Tax?

In theory, there is no place for a corporate tax in an expenditure tax regime; corporations do not consume. But repeal of the corporate tax would raise serious problems. The first would be making up the revenue loss; despite the gradual decline of the corporate tax over the last three decades, it still will raise about one-fifth as much in revenues as the individual income tax after recovery of corporate tax revenues from the recent recession. Elimination of the tax would require the transfer of that burden to some other sector in the economy, given that revenues are in short supply. Such a transfer would add to the pains of transition (discussed in more detail later). Further, if the revenue burden is added to the expenditure tax, it would drive up marginal tax rates even further, especially if the burden is imposed on the high-income (or high-consumption) taxpayers who probably bear that burden in the final analysis under current law. As was noted earlier, the level and steepness of marginal tax rates even absent this factor could impose economic costs under the expenditure tax.

Another problem in an expenditure tax regime with no corporate tax would be a potential for disguising consumption as business expenses. That potential is already present under the income tax, and would be present under the expenditure tax whatever the corporate tax arrangement. But the corporate tax return at least allows a check on corporate receipts and expenses that might help keep the firms and their owners honest, and perhaps provide the information needed to track down those who transgress. Without a corporate tax per se, a reporting arrangement of business expenses might be necessary.

If repeal of the corporate tax proves impossible for revenue or political reasons, part of the potential for simplification under the expenditure tax will be lost. The skeletal corporate tax that remains will have no conceptual role in an expenditure tax system.

Is Expensing Efficient and Equitable?

The expensing of physical investment, like the tax deductibility of cash saving, yields a zero effective tax rate on income from capital. Because that effective tax rate does not vary with the characteristics of the asset, the expenditure tax is perfectly neutral among different investment choices. This neutrality is correctly described as an efficiency advantage.

Nonetheless, expensing can raise problems. The up-front full deduction for investment can open the door to tax manipulation through leveraging early tax savings and postponing taxability of income. Further, the deduction is worth the most to taxpayers with taxable consumption to offset at high marginal tax rates. Thus, the out-of-pocket cost of an investment to an entrepreneur is the full market price if there is no taxable consumption to offset, but a fraction of the price if the investor is in a high rate bracket. And as was noted earlier, tax rates under the expenditure tax will be higher and steeper than under an income tax of equal yield and with an otherwise equivalent base, exaggerating this problem.

Saving is an unambiguous concept in theory, but it is much more slippery in practice. It certainly includes purchases of stocks and bonds.... But how about purchases of antiques...?

The tax manipulation problem would be held in check under the expenditure tax by the full taxation of borrowed money, though thorough regulations and vigilant administration would be needed to control timing scams. But this whole issue reflects on the broad arguments that a zero rate of tax on income from capital is preferable, and so any movement toward that destination is desirable, and any movement away from it is undesirable. This rationale is used for policies such as expansion of IRA accounts, or other selective and limited exclusions of capital income from tax. As a result of such policy steps, our income tax is somewhere between a true income tax and a true expenditure tax.

In "moving towards an expenditure tax," the tax system has been riddled with inefficient incentives and tax shelter opportunities. The IRA provision provides no marginal incentive to many taxpayers with the wherewithal to save, but instead provides them with a windfall for saving that they would have done anyway. The windfall is larger, the higher is the taxpayer's income and marginal tax rate. Other taxpayers are given an open invitation to arbitrage the tax law, with a tax deduction for interest paid on borrowing that is used to make tax-deductible deposits earning tax-excludable interest. The net interest exclusion (to take effect in 1985) avoids the arbitrage problems, but again provides limited marginal incentives and windfalls positively correlated with wealth. The accelerated cost recovery system (ACRS) has opened new vistas of tax avoidance and abuse in the guise of encouraging investment and being "like expensing." Again, the tax savings go to taxpayers with large amounts of income to shelter from tax, bypass new firms, and leave firms with histories of net operating losses prey for tax-motivated mergers. Absent those mergers, unprofitable firms must face higher out-of-pocket costs of capital. The trappings of the expenditure tax that are transferred to the income tax are those that lose revenue, allow tax abuse, and provide upside-down subsidies to taxpayers; the one ingredient that is ignored is the one that would seal off the leakages: the taxation of borrowed money.

To summarize, the expenditure tax is theoretically neutral with respect to investment, but its steep marginal tax rates and up-front deductions would leave the potential for tax manipulation and relative advantages for high bracket taxpayers. The taxation of borrowed money would help significantly in minimizing such costs. Without the taxation of borrowing, however, or in an income tax sprinkled with tax-reducing expenditure tax features, tax abuse could run wild and inefficient subsidies would abound. Either a true income tax or a true expenditure tax would be preferable to a hybrid that did not include the taxation of borrowed money as a constraint on abuse.

Can We Get There From Here?

Several difficulties in the transition to an expenditure tax have already been mentioned. For one, an expenditure tax that eliminated the preferential treatment of housing would wreak havoc with the balance sheets of millions of homeowners. For another, the average taxpayer would require a virtual reeducation in tax principles to cope with the taxation of borrowed money and the tax deductibility of saving. Beyond these factors, other considerations suggest that the expenditure tax may be unattainable.

The treatment of taxpayers near retirement would be complex and crucial. If the expenditure tax were enacted, new and recent retirees would face a double tax on savings in taxable forms; money in bank accounts or taxable fixed-income securities would be taxed again when consumed. To avoid this double tax, some form of deduction or basis adjustment for previously taxed wealth would be necessary; such an adjustment would be extraordinarily complex. But at the same time, savings in untaxed forms such as IRAs, Keoghs, tax-exempt pension contributions and as-yet unrealized capital gains would properly be taxable when consumed. Distinguishing between taxed and untaxed wealth for all taxpayers would be a major burden on the revenue authorities and the taxpayers themselves.

The expenditure tax has unique theoretical properties with respect to lifetime consumption and income, but those properties are questionable advantages at best in practice.

Another transition problem would be the identification of all wealth. Taxpayers who concealed wealth at the time of the transition could withdraw it later for consumption and pay no tax. Thus, part of the transition effort would be the creation of complete balance sheets for all taxpayers. This would be a formidable task.

The appearance of such a transition would surely contradict much of the public's motivation for tax restructuring. Those who held large amounts of wealth in taxable forms would be entitled to basis adjustment deductions upon transition, because from the expenditure tax viewpoint, the taxes already paid on interest and dividends earned are in effect early payments of the tax that should be due later, when that wealth is finally consumed. But those deductions could greatly reduce or eliminate tax for such taxpayers over a significant length of time. The risk is that taxpayers who resent a tax system with apparently optional payment for the well-connected will be even more hostile to a new system that formally eliminates tax in such cases, if only for a time.

Finally, there is the issue of international coordination. The U.S. would be the only nation on earth with a personal expenditure tax, and so all of our tax treaties would have to be adjusted to reflect the new tax. There is a knotty conceptual question in whether we should continue to allow a foreign income tax credit against our expenditure tax.

The transition to an expenditure tax would clearly be difficult. There is little or no precedent for the changes in tax accounting, forms, and practices that would be required. Our income tax evolved over almost 30 years in which the total federal tax take was less than half the share of GNP of just the income tax today. To change to an expenditure tax now, in the midst of a continuing budgetary struggle, would be a riverboat gamble writ large.

Conclusion

The foregoing discussion illustrates the theme of this paper: that the case for the expenditure tax is based on a narrow view of the world that excludes some criteria of sound tax policy. To reiterate briefly, and make this theme more explicit:

The case for the expenditure tax focuses on capital to the exclusion of labor, and on efficiency to the exclusion of fairness. In a rush to minimize and eliminate the tax burden on capital, the expenditure tax argument ignores the issue of the propriety and the desirability of loading the entire tax burden on labor.

The case for the expenditure tax focuses on rare special cases to the exclusion of everyday situations, and on theoretical as opposed to practical considerations. Thus, to illustrate the alleged fairness of the expenditure tax, dissolute millionaires dissipating their wealth are painted as fitting objects of a tax on expenditure, ignoring the probably more common occurrence of modest-income families struggling with bouts of involuntary unemployment. Likewise, the expenditure tax argument often highlights the theoretical property of equal lifetime tax liabilities for equal lifetime incomes in present value terms, even though the assumptions underlying this property are implausible from a practical point of view. Even the lifetime income averaging interpretation of the tax on consumption overlooks the practical problems of taxing people more lightly in their prosperous years and more heavily in their poorer times. Finally, especially as it pertains to a hybrid tax closer to an expenditure than an income tax, the argument ignores the problems of new and recently unprofitable firms, and the potential for abuse of tax subsidies for saving that are not protected by taxation of borrowing.

The case for the expenditure tax focuses on a future steady state to the exclusion of problems of transition. The costs of making an expenditure tax operational would be enormous. Dealing with prior accumulated wealth would be an extremely difficult problem, as would educating the population at large in expenditure tax concepts.

In short, the benefits of moving to an expenditure tax, both in terms of increased capital formation and improved fairness, are highly questionable. The costs, however, are not.

As was noted at the outset, the current income tax is nothing to write home about. And at least if one ignores the problems of transition, a true expenditure tax surely would be preferable to the current hybrid law. But a fraction of the political and administrative energy needed to effect that change certainly could achieve substantial improvements in the income tax.

In sum, the income tax is not dead yet. It is adapted to our terrain through 70 years of irreplaceable experience. Its theoretical ungainliness is at least in part the result of accommodation to practical realities that are as important as theoretical considerations. Given the proper attention, the income tax can best balance all of the criteria of a good tax system.

PRIOR COVERAGE OF CONSUMPTION TAX ISSUES

Details of the use of consumption taxes by countries belonging to the Organization for Economic Cooperation and Development, extracted from a Tax Foundation news release, appear in *Tax Notes*, December 19, 1983, p. 1050.

The American Council for Capital Formation (ACCF) has stated that the U.S. tax system will gradually shift towards broad-based consumption taxation beginning in 1985. For a summary of ACCF's position, see *Tax Notes*, December 5, 1983, p. 914.

For details of the Progressive Consumption Tax Act of 1983, H.R. 4442, introduced by House Ways and Means Committee member Cecil (Cec) Heftel, D-Hawaii, see *Tax Notes*, December 5, 1983, p. 913.

Treasury's endorsement of a consumption-based tax system appears in *Tax Notes*, October 24, 1983, p. 349.

For a special report entitled "Revising the Individual Income Tax," by Cynthia Francis Gensheimer, see *Tax Notes*, August 8, 1983, pp. 427, at 428.

For excerpts from an address by Council of Economic Advisers Chair Martin Feldstein, in which he links tax reform and consumption taxation, see *Tax Notes*, January 24, 1983, pp. 347-348.

MEETINGS AND SEMINARS

ABA'S SEMINAR ON MULTI-STATE BANKING. The ABA's Division of Professional Education will present a seminar on multi-state banking, in Chicago, Ill. on May 3-4, 1984. The seminar will cover both regulatory and tax aspects of multi-state banking. It will also discuss the Interstate Taxation of Depositories Act, a legislative proposal of the ABA to minimize many of the present state tax anomalies in the area. For further information, contact ABA, National Institutes, 10 West 35th Street, Chicago, Ill. 60616, or telephone (312) 567-4725.

SPECIAL REPORT

TAX ANALYSTS

THE TAX SHARES BOOMLET

by Joseph J. Minarik

Joseph J. Minarik is a Senior Research Associate at the Urban Institute in Washington, D.C. The views expressed in this special report are his own.

In this article, Minarik discusses recently released IRS statistics that have provoked a flurry of editorials and articles in The Washington Post, The Wall Street Journal, and other papers. The statistics relate to the share of federal income taxes paid by individuals in various tax brackets, and have led to claims that the 1981 tax cuts are inducing greater work effort and investment on the part of upper-bracket taxpayers.

Minarik analyzes the statistics which the journalistic protagonists cite and concludes that these data do not furnish a basis for claims that the 1981 tax cuts are producing the effects claimed by supply-side proponents.

Devotees of supply-side economics are trumpeting the recently released Internal Revenue Service (IRS) preliminary 1982 individual income tax return statistics. These figures show that taxpayers with more than $50,000 of adjusted gross income (AGI) paid a greater share of federal income taxes than they did in the preceding year. This finding seems to accord with the major supply-side premise that tax cuts induce greater work effort and investment, thereby increasing incomes.

The new statistics also seem to rebut the "fairness" issue concerning the 1981 tax rate cuts. Critics claimed that the across-the-board rate cuts were too generous to upper-income persons. Supply-siders now counter that these taxpayers are bearing a greater, not a lesser, share of the total tax load.

So far, the 1982 tax shares and their change from 1981 have been examined in isolation; there is no sense of how these figures compare with earlier experience. There is also no real understanding of what forces can cause the tax shares to change in any given year. It would be useful to examine these figures in more detail and in historical context.

What Moves the Tax Shares

There are at least four factors that affect the tax shares of different income groups in any given year.

Changes in Tax Laws. The first relevant factor is fairly obvious: changes in the tax laws. A tax cut targeted on low- or high-income persons will change the tax shares directly, at least under static assumptions. Despite the immediate reduction of the highest tax rates to 50 percent, the 1981 tax cuts were approximately equal in percentage terms across the board. (According to Joint Committee on Taxation estimates, taxpayers with over $50,000 of income would pay 33.8 percent of income taxes under the prior law, and received 35.1 percent of the 1982 tax cut.) So by simple mathematics, the cuts should have no significant effect on tax shares. This does not mean that the tax shares would have been constant in the absence of the 1981 cuts. Rather, it means that the tax shares would have been changed by other relevant factors.

Growth and Inflation. The IRS statistics show taxes of income groups denominated in nominal dollars. Thus, the amount of taxes paid by taxpayers with incomes over $50,000 would increase over time for no reason other than inflation (and even if the tax brackets and exemptions were indexed). An increasing share of the taxpaying population would be pushed over the nominal $50,000 barrier, and their taxes would therefore constitute an increasing share of the total. Real growth has the same effect. So we should expect the tax share above any nominal income limit to increase in the normal course of human events.

Economic Fluctuations. The rate of economic growth can affect tax shares significantly. When the economy falls into a recession, people at the lower and middle parts of the income scale lose jobs and income, and so the tax shares of these groups fall. Conversely, when the economy recovers, the incomes and tax shares of the low- and middle-income groups increase. Tax shares at the top of the scale, of course, move in the opposite direction.

The Stock Market. The rise and fall of the stock market have impacts similar to the rise and fall of the economy, but affect upper- rather than lower-income groups. When the market goes up, wealthy taxpayers accrue large capital gains; if they choose to cash them in, their taxable incomes and tax shares can increase substantially. On the other hand, when the market goes down, accrued gains disappear and realized gains tend to fall, and so the tax share of the highest income groups falls as well.

It is hard to understand such fascination over an increase in a statistic that always goes up anyway.

What the Record Shows

Table 1 shows the tax share of the over $50,000 income group from 1972 to 1982.

The obvious first conclusion from these data is the strength of the effect of growth and inflation. Over the ten-year period, the tax share of this group has never fallen. Excluding 1982 for the moment, the average increase has been 1.7 percent per year.

Table 1

TAX SHARES OF RETURNS WITH OVER $50,000 IN ADJUSTED GROSS INCOME
(1972-1982, percent)

Year	Share	Increase
1972	17.9	1.5
1973	18.0	0.1
1974	19.0	1.0
1975	20.6	1.6
1976	22.4	1.8
1977	24.1	1.7
1978	25.6	1.5
1979	28.8	3.2
1980	31.4	2.6
1981	33.2	1.8
1982	35.8	2.6

Source: *IRS Statistics of Income, Individual Income Tax Returns*, various years; and *SOI Bulletin*, Winter 1983-1984.

Beyond the power of the trend, there are some apparent cyclical effects. The smallest increase came in 1973, when the economy grew strongly. The largest increases came from 1979 through 1981, when the nation was entering a recession and inflation was accelerating. This history confirms the reasoning above.

Further, the tax share of the over $50,000 group increases at an increasing rate. This is because the average income is growing closer to the $50,000 level, and so each year's inflation and growth pushes an increasing number of taxpayers past the $50,000 level. All else equal, this trend would be expected to continue.

This increase in tax shares, caused as it is by a burst of capital gains realizations, is not an indication of the more rapid economic growth that supply-side economics predicts.

In light of the causal factors described above, the 1982 tax share is hardly surprising. The tax rate cuts had no apparent effect on the tax shares, as expected. The general trend of the preceding years continued, reinforced by still rapid (but slowing) inflation, a recession that continued through almost year-end, and a stock market boom beginning about mid-year. If there is any surprise, it is that the tax share increased less than it had in 1979-1980. Perhaps this was the result of the slight upper-income bias in the 1982 installment of the tax cuts.

A Closer Look at 1982

So the increase in the over-$50,000 tax share in 1982 is by no means extraordinary compared to the preceding three years, or even the preceding decade. Nonetheless, the 1981 and 1982 figures might be worth a closer look.

The increase in the over-$50,000 tax share in 1982 is by no means extraordinary compared to the preceding three years, or even the preceding decade.

Table 2 shows the changes in tax shares for six income groups above the $50,000 level. This shows that the increase in the share of tax liabilities is highly concentrated at the very top of the income scale. The 8,203 returns with over $1 million of AGI in 1982 (less than two-tenths of one percent of returns above $50,000 of AGI) paid 2.5 percent of total income taxes, 0.8 percent more than the corresponding group in 1981. This is almost one-third of the total increase for the over $50,000 group. Taxpayers with from $500,000 to $1 million of AGI increased their share of total taxes by 0.6 percent. This makes the total increase above the half-million-dollar level (less than one percent of all returns over $50,000) more than half of the increase for the entire larger group. The increases for taxpayers under the $100,000 level were quite modest; indeed, in terms of numbers of tax returns, those groups shrank between the two years.

Table 2

TAX SHARES OF INCOME GROUPS OVER $50,000
(1981 and 1982, percent)

Income Group (thousands)	1981	1982	Increase
$50 - $75	12.8	12.9	0.1
$75 - $100	5.2	5.3	0.1
$100 - $200	7.6	7.9	0.3
$200 - $500	4.5	5.1	0.6
$500 - $1,000	1.4	2.0	0.6
$1,000 +	1.7	2.5	0.8
All above	33.2	35.8	2.6

Source: *IRS Statistics of Income, Individual Income Tax Returns, 1981*, and *SOI Bulletin*, Winter 1983-1984.

The salient fact here is that the increase in tax shares was extremely top-heavy. This is significant in part because such an increase could be only temporary. Taxpayers in the $1 million AGI neighborhood receive much of their income in the form of capital gains. Detail for 1982 is not yet available, but in 1981, 33.7 percent of AGI on returns with more than $1 million of income was received as capital gains. Table 3 shows that AGI on returns over the $1 million level increased by almost 58 percent between 1981 and 1982, but no income item identified in the preliminary 1982 statistics increased that fast. AGI not included in any of those categories increased by more than 83 percent; and almost 80 percent of 1981 income in those categories was capital gains. The unspecified 1982 income items other than capital gains are quite small and extremely unlikely to have set off this burst of rapid growth.

Capital gains can go up, as they did in 1982; or they can go down, when the stock market falls, or when the burst of selling that follows a capital gains tax cut runs out of steam. The tax share of returns over $500,000 of AGI fell between 1979 and 1981, when capital gains realizations grew less rapidly than the economy as a whole. So even the rapid growth at the extreme top of the income scale could slow or reverse after 1982.

But perhaps the most important lesson here regards the main contention of supply-side economics, rather than the fairness issue that is now at center stage. Capital gains realizations are not new production; they are merely by-products of exchanges of existing assets. Thus, this increase in tax shares, caused as it is by a burst of capital gains realizations, is not an indication of the more rapid economic growth that supply-side economics predicts.

The bottom line is that upper-income taxpayers paid a greater share of total income taxes in 1982, but total income taxes went down. So supply-side economics did not deliver the increased tax revenues its advocates promised, at least in 1982.

Upon careful reflection, this boomlet of interest in tax shares is quite puzzling. It is hard to understand such fascination over an increase in a statistic that always goes up anyway.

Table 3

INCOME SOURCES OF RETURNS WITH AT LEAST $1 MILLION OF ADJUSTED GROSS INCOME
(1981-1982)

Source	1981	1982	Growth
(thousands)	(billions of dollars)	(billions of dollars)	(percent)
Adjusted gross income	11.129	17.552	57.7
Wages and salaries	2.186	3.178	45.4
Interest and dividends	3.803	5.322	39.9
Business	0.544	0.518	–4.8
Farm	–0.106	–0.086	n.a.
Unemployment compensation	neg.	neg.	n.a.
Other	4.702	8.623	83.4

Source: *IRS Statistics of Income, Individual Income Tax Returns, 1981*, and *SOI Bulletin*, Winter 1983-1984.

N.A.: Not applicable.

Neg.: Less than 0.0005.

Income components listed are those included in the preliminary 1982 IRS statistics. "Other" component is a residual computed by the author, and includes long- and short-term capital gains, alimony received, state income tax refunds, pensions and annuities, rent, royalties, sales of property other than capital assets, partnership income, estate and trust income, small business corporation income, and all income not elsewhere classified.

Representative Long. Thank you, Mr. Minarik. Mr. Auerbach.

STATEMENT OF ALAN J. AUERBACH, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, AND RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. Auerbach. Thank you, Mr. Chairman. I have a prepared statement that I will read from and I have an article that I would like to submit for the record.

Representative Long. It will be made part of the record.

Mr. Auerbach. Thank you. I am delighted to have this opportunity to present my views on the current state of the income tax, particularly on the corporate tax, and on a variety of measures that might be considered to change it, including the Bradley-Gephardt proposal.

If there is any view that unites observers of different persuasions, be they in Government, business, or the economics profession, it is that the U.S. corporate income tax is a mess. As to what specifically should be done, there is less agreement. Let me say at the outset that I would strongly oppose the repeal of the corporate tax. As I will elaborate on in the remainder of my comments, I believe this would constitute a large windfall to the owners of corporations while at the same time providing a negligible increase in the overall incentive for such corporations to invest. Even were Congress to consider such a radical step as a move to the taxation of consumption at the individual level, a logical role for a corporate tax not unlike the present one would remain.

One should not take this preamble as a defense of the corporate tax as now structured. As I discuss in the paper included as an appendix to these comments, the corporate tax distorts corporate investment decisions in a number of critical ways. First, through the investment tax credit and ACRS depreciation schedules, it provides incentives to overinvest in some assets and underinvest in others. The magnitude of this distortion, measured as a fraction of GNP, has grown over time, despite the declining relative size of corporate tax revenues. Moreover, the incentive to invest is influenced by the rate of inflation, since depreciation allowances are based on historical cost and not indexed for changes in the price level. Three years ago, when the merits of ACRS were being debated, some of its proponents argued that such an acceleration of depreciation allowances was needed in lieu of explicit indexing. I invite them to support a repeal of ACRS now that the inflation rate has been reduced so successfully. Under an indexing scheme, such continual adjustments would be unnecessary.

Another serious problem is that of tax losses. Congress recognized in 1981 that the further acceleration of depreciation allowances would throw more firms into a position of having insufficient taxable income to use all of their deductions. The legislative solution to this problem was the transfer of such deductions, through safe harbor leasing. While this was an imperfect palliative, its gradual removal by the 1982 and 1984 tax acts leaves the original problem unsolved. Firms face different incentives to invest, even when purchasing the same assets, according to the availability of taxable income from other sources. This not only discriminates among firms, it also encourages their combination through merger or acquisition as a way of transferring unused tax benefits.

The Bradley-Gephardt Fair Tax Act would address certain problems associated with the corporate tax while at the same time maintaining the level of revenue from the tax at roughly what would be collected under the current system. Its most important provisions would reduce the corporate tax rate to 30 percent while replacing ACRS and the investment tax credit with a system of six open-ended accounts based on the old ADR lifetimes and 250 percent declining balance depreciation.

On the positive side, this new system would reduce substantially the differentials in the tax treatment accorded various assets, given current rates of inflation. It is also worth adding that the open-ended account system, similar to that proposed by President Carter in 1980, would simplify and rationalize the treatment of used asset sales and purchases, providing for a decrease in the seller's depreciable basis equal to the increase obtained by the purchaser. This neutral treatment would replace the current complicated application of recapture provisions and capital gains treatment when assets are sold.

I wish that the Fair Tax Act provided for price-level indexation of these depreciation allowances. This same concern applies to the individual income tax provisions. Allowing the inflation rate to dictate the real level of tax collections and investment incentives seems an unnecessary economic punishment for us to be inflicting on ourselves and to be continuing to do so.

The reduction in the top corporate rate would serve both to preserve the incentive to invest in the face of scaled-down depreciation allowances, and to prevent income shifting that might arise if the top corporate and individual rates differed greatly. Here again, I would have preferred a somewhat different provision. My concern is best illustrated by recalling the economic argument that targeted investment incentives, such as investment tax credits and accelerated depreciation, provide a greater "bang for the buck" than general rate reductions because companies only obtain the tax reduction to the extent that new investments are made. In the economist's parlance, such policies reduce the marginal tax rates that influence investment behavior more than they do average tax rates, as measured by total tax collections. Compared to such incentive policies, one that reduces the value of depreciation allowances while lowering the corporate tax rate is probably not especially effective. To oversimplify, it trades an increase in marginal tax rates for a decrease in average tax rates. The net effect would probably be a decrease in the overall incentive for firms to invest.

I would hasten to add that this difficulty can be addressed within the basic system outlined in the Fair Tax Act. One approach would be to phase in the rate reduction, thereby limiting the extent to which current rather than new sources of corporate income would benefit from the decrease. One might even consider the imposition of a temporary corporate tax surcharge to recoup some of the windfall provided through the eventual rate reduction.

The Bradley-Gephardt plan does not deal directly with the problem of tax losses, although it reduces it indirectly through its deceleration of depreciation allowances. I would still like to see some system that would more thoroughly correct this problem, such as the payment of interest on net operating loss carry forwards.

To summarize, I think the fair tax version of the corporate tax, with amendments, could represent an improvement over the current tax system. At present, there are certain aspects of the plan which require further consideration.

In light of my previous comments, it is now very easy to explain why I would find corporate tax repeal unsatisfactory. As discussed in the article for the hearing record, the various incentive provisions that currently exist for new investment mean that firms will pay very little taxes in the future on the income from such investments. The bulk of corporate tax collections will come from assets already in place. Hence, a corporate rate reduction, here not to 30 percent but to zero, would provide virtually no increase in the marginal incentive to invest while giving away what remains of the corporate tax. As the Fair Tax Act attempts to do, distortions in the choice among asset can be removed without simply removing the entire tax.

In closing, let me address the role of the corporate tax under a system of individual consumption taxation, an alternative that both Congress and the Treasury are currently considering. Some commentators have suggested that the corporate tax should be repealed upon enactment of a consumption tax because corporations don't consume. This is a non sequitur. One could equally well use the argument to oppose property taxes, social security taxes, or any other taxes not tied directly to consumption. The key element of the consumption tax is that it does not tax the return to new savings, at the individual or corporate level. This can be accomplished under a cash flow corporate tax. As described in the article for the hearing record, such a tax would replace ACRS and the investment tax credit with the immediate writeoff of investments, but at the same time would include borrowing in the tax base. This system would differ in its economic effects from outright repeal of the tax primarily in its failure to deliver several hundred billion dollars from the general taxpayer to the owners of corporate equities.

[The article referred to by Mr. Auerbach for the record follows:]

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Corporate Taxation in the United States

THE CORPORATION INCOME TAX has been the focus of much criticism and debate in the United States during the past decade. Many hold it responsible for the low level of business investment in the United States, and it has been criticized as a fundamentally unfair and illogical tax because it taxes corporations as independent entities, regardless of the tax brackets of individual shareholders. Much of the academic discussion in the 1970s about reform of the corporate tax centered on the integration of corporate and individual income taxes, to make the corporate tax essentially a withholding mechanism for the individual income tax.[1] More recently the emphasis has shifted toward reform by repeal, and indeed President Reagan himself has called for the abolition of the corporate tax.

Any analysis of the current economic effects of the U.S. corporate tax should begin with the recognition of what has happened over the years to corporate tax revenues. Put simply, the corporate tax has been disappearing. The marked drift in composition of federal revenues away

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[1] See Charles McLure, *Must Corporate Income Be Taxed Twice?* (Brookings Institution, 1979), and Martin Feldstein and Daniel Frisch, "Corporate Tax Integration: The Estimated Effects on Capital Accumulation and Tax Distribution of Two Integration Proposals," *National Tax Journal*, vol 30 (March 1977), pp. 37–52.

from the corporate tax is illustrated in table 1, which presents the revenues from income taxes since 1953 as a percentage of federal revenues and GNP. The year 1953 is significant, for it was in 1954 that Congress passed the first of many tax acts that have successively shortened the lifetimes over which tax deductions for depreciation could be taken and accelerated the depreciation deductions within such lifetimes. The common practice through 1953 was to use straight-line depreciation for tax purposes over the allowed "useful" lives for assets. In that year the corporation income tax accounted for 28.4 percent of federal receipts and 5.4 percent of GNP. Of total income tax receipts, it accounted for about 39 percent. Throughout the late 1950s and most of the 1960s, corporate revenues provided about one-third of total income tax revenues. A familiar rule of thumb from that era was that tax cuts should be "one-third business, two-thirds individual," perhaps reflecting this relatively stable ratio. By 1980, the year before passage of the Economic Recovery Tax Act, corporate revenues had declined to half the level that existed in 1953, relative to GNP. The experience since then and estimates for the next five years show important additional erosion in the corporate tax as a revenue source.

This steady downward trend stands in contrast to the stability of the individual income tax, which has ranged only between 42.8 percent and 49.0 percent of revenues over the same period, and between 7.4 percent and 9.9 percent of GNP. The corporate tax will provide revenue in 1983 equal to only a small fraction of the concurrent annual federal deficit. It is in light of this low level of receipts that many have called for the abolition of the corporate tax; though if the trend in table 1 continues, little action toward this goal might seem to be required. However, changes in aggregate revenues convey only limited information about the economic impact of the corporate tax. Underlying these statistics are important distortions in the ways firms behave, with respect not only to the overall level of investment but also financial policy, asset choice, and the degree of risk-taking. The decline in corporate tax collections does not necessarily indicate a corresponding reduction in such distortions.

The purpose of this paper is to provide an economic analysis of the impact of the corporate tax in the United States as it is now and has been during the postwar years. Among the findings are the following.

1. Even accounting for inflation, the corporate tax wedge faced by

Table 1. Sources of Federal Revenues, Fiscal Years 1953–88

	Individual income tax[a]		*Corporate income tax*	
Year	*Percent of federal revenues*	*Percent of GNP*[b]	*Percent of federal revenues*	*Percent of GNP*[b]
1953	45.2	8.6	28.4	5.4
1954	46.0	8.3	26.3	4.7
1955	44.1	7.4	28.0	4.5
1956	44.0	8.0	28.2	5.1
1957	45.3	8.3	25.7	4.7
1958	46.5	8.1	22.9	4.0
1959	44.7	7.8	25.1	4.4
1960	44.8	8.4	23.5	4.4
1961	45.9	8.3	21.1	3.8
1962	45.4	8.4	21.8	4.0
1963	45.1	8.3	21.2	3.9
1964	43.9	8.0	22.2	4.0
1965	42.8	7.4	22.6	3.9
1966	43.3	7.6	23.2	4.1
1967	44.1	8.1	20.8	3.8
1968	44.7	8.2	20.7	3.8
1969	47.5	9.6	19.4	3.9
1970	48.3	9.5	16.9	3.3
1971	45.7	8.2	16.6	3.0
1972	47.1	8.5	16.0	2.9
1973	44.6	8.1	17.1	3.1
1974	45.2	8.6	16.0	3.0
1975	45.0	8.2	14.7	2.7
1976	43.6	8.0	16.7	3.1
1977	45.4	8.7	16.1	3.1
1978	45.0	8.6	16.2	3.1
1979	46.3	9.2	15.8	3.1
1980	47.6	9.5	13.3	2.7
1981	47.5	9.9	11.5	2.4
1982	49.0	9.9	8.1	1.6
1983[c]	47.2	8.9	6.6	1.3
1984[c]	45.1	8.4	8.5	1.6
1985[c]	44.9	8.4	9.1	1.7
1986[c]	45.0	8.3	9.6	1.8
1987[c]	45.2	8.3	10.1	1.9
1988[c]	44.6	8.3	10.0	1.8

Sources: The 1953–57 period—*Economic Report of the President, January 1977*, table B-72; 1958–82—*Economic Report of the President, February 1983*, table B-76; 1983–88—Congressional Budget Office, baseline budget projections for fiscal years 1984–88.

a. Includes estate and gift taxes and nontax receipts, the last of which are not a significant amount.

b. For 1953–82, fiscal year revenues are divided by calendar year GNP.

c. Estimated.

fixed investment in the aggregate has declined steadily since the early 1950s. At its minimum, in 1981, the marginal corporate tax rate was less than one-third of its 1953 level.

2. Despite this reduction in the marginal tax rate on capital taken as an aggregate, the social cost of misallocation of capital within the corporate sector that resulted from differential asset taxation, measured as a fraction of the corporate capital stock, increased over the same period, reaching an estimated peak of 3.90 percent in 1973, and equaling 3.19 percent in 1981 with the passage of the Economic Recovery Tax Act.

3. The absence of tax refunds for losses incurred by corporations results in firms with different earnings histories having different incentives to invest. Fully taxable firms quite possibly possess a stronger incentive to invest than those in the apparently favorable position of having previous losses to carry forward. This prospect has been increased by recent legislation accelerating depreciation schedules.

4. The effect of inflation on the incentive to invest is highly sensitive to the proportion of debt finance and the gap between ordinary personal and corporate tax rates. Differences in assumptions about these parameters have led to greatly varying estimates of the impact of inflation, with the direction as well as the magnitude subject to dispute.

5. Tax reform proposals should distinguish between tax revenues and marginal tax rates. Given the current pattern of asset taxation, much of the present value of revenues that will come from the corporate tax can be attributed to assets already in place. Hence abolition of the corporate tax would accomplish a small reduction in the average marginal tax rate at the expense of a large, essentially lump-sum transfer to the owners of existing capital. This transfer would have been approximately $427 billion in 1981.

The paper begins with a review of the corporate tax and its provisions and the major changes that generated the pattern of revenues presented in table 1.

The Corporate Tax: 1953–81

The corporate tax is essentially a flat rate tax; it is currently 46 percent.[2] There has been little movement in the statutory corporate tax rate during the past three decades. As shown in the second column of table 2, the rate was reduced from 52 percent to 48 percent by the 1964 tax cut, raised temporarily by the 10 percent Vietnam War surcharge, and lowered again by the tax act of 1978 to its current level. Most of the "action" in the corporate tax has come from changes in the tax base.

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[2] Under current law the first $100,000 of a corporation's income is taxed at rates

The tax base for a nonfinancial corporation investing in fixed assets is derived by subtracting from gross sales the costs of inputs (including wages and materials), capital costs (through depreciation allowances), and interest payments. This base is effectively reduced when any of these components increases or when tax credits are allowed against calculated tax liabilities. Through various legislation, there have been increases in levels of depreciation allowances and credits at any given level of income. Increases in the inflation rate have brought declines in the real value of depreciation allowances and measured materials costs and increases in interest payments.

Either through shortened tax lifetimes or increased speed of write-off over such lifetimes, depreciation allowances were accelerated in 1954, 1962, 1971, and 1981. All these actions had the effect of raising the present value of depreciation allowances received per dollar invested. The investment tax credit was introduced in 1962, briefly suspended in 1966, removed in 1969, reinstated in 1971, increased in 1975, and altered by both the 1981 and 1982 tax acts.[3] Thus, there has been a general *legislative* movement toward reduced corporate taxation, since most nonresidential fixed investment is undertaken by corporations.

As has been emphasized by many authors, inflation affects taxable corporate profits in three important ways.[4] To the extent that the first-

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below the maximum rate of 46 percent. The only important class of corporation taxpayers without most income in the top bracket are companies with negative taxable income that face a tax rate of zero. This is discussed further below.

[3] For a historical review of these changes, see Alan J. Auerbach, "The New Economics of Accelerated Depreciation," *Boston College Law Review*, vol. 23 (September 1982), pp. 1327–55.

[4] See, for example, John B. Shoven and Jeremy I. Bulow, "Inflation Accounting and Nonfinancial Corporate Profits: Physical Assets," *BPEA, 3:1975*, pp. 557–98; T. Nicholaus Tideman and Donald P. Tucker, "The Tax Treatment of Business Profits Under Inflationary Conditions," in Henry J. Aaron, ed., *Inflation and the Income Tax* (Brookings Institution, 1976), pp. 33–77; Martin S. Feldstein and Lawrence Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector," *National Tax Journal*, vol. 32 (December 1979), pp. 445–70; and Alan J. Auerbach, "Inflation and the Tax Treatment of Firm Behavior," *American Economic Review*, vol. 71 (May 1981, *Papers and Proceedings, 1980*), pp. 419–23.

Table 2. Average Corporate Tax Rates, 1953–82
Percent

Year	*Average corporate rate*[a]	*Statutory corporate rate*	*Difference*
1953	55.9	52.0	−3.9
1954	50.0	52.0	2.0
1955	48.4	52.0	3.6
1956	50.3	52.0	1.7
1957	49.4	52.0	2.6
1958	49.4	52.0	2.6
1959	47.6	52.0	4.4
1960	47.7	52.0	4.3
1961	46.9	52.0	5.1
1962	42.4	52.0	9.6
1963	42.2	52.0	9.8
1964	40.5	50.0	9.5
1965	38.6	48.0	9.4
1966	39.6	48.0	8.4
1967	39.4	48.0	8.6
1968	44.0	52.8	8.8
1969	46.4	52.8	6.4
1970	47.9	49.2	1.3
1971	45.1	48.0	2.9
1972	43.1	48.0	4.9
1973	45.2	48.0	2.8
1974	54.4	48.0	−6.4
1975	45.8	48.0	2.2
1976	46.2	48.0	1.8
1977	43.5	48.0	4.5
1978	43.2	48.0	4.8
1979	45.0	46.0	1.0
1980	46.6	46.0	−0.6
1981	42.6	46.0	3.4
1982	36.5	46.0	9.5

Sources: Average rates are from *Economic Report of the President, February 1983*, table B-82; statutory rates are from appendix A.

a. Corporate tax liability as a percentage of corporate profits with inventory valuation and capital consumption adjustments.

in, first-out (FIFO) inventory method is used, rising prices lead to an understatement of materials costs, and purely nominal "inventory profits" are taxed. Because depreciation allowances are based on historical asset cost, their real value declines with increases in the price level. Finally, nominal interest payments include an inflation premium that is essentially a return of principal to bondholders. Yet these payments are fully deductible to the corporate borrower. This last effect works against the first two, lowering corporate tax liabilities, though there may be offsetting effects at the individual level, both with respect to the taxation of interest received and nominal capital gains on stock.[5]

The combined impact of changes in the tax law and, through modifications in the inflation rate, implicit changes in the treatment of inventories and depreciation can be seen in table 2, which compares average corporate tax rates (corporate taxes as a percentage of corporate profits corrected with the capital consumption and inventory valuation adjustments) over the past thirty years with the statutory tax rates over the same period. (Since nominal interest payments are deducted from this profits measure, as well as the tax base, increases in interest payments lower both numerator and denominator of the average tax rate calculation.) The primary differences in the two tax rates for a given year come from investment tax credits and discrepancies between estimates of actual depreciation and materials costs and those actually deducted on tax returns. When the statutory rate exceeds the average rate, the effect of investment tax credits and accelerated depreciation allowances outweighs the erosion of such allowances and taxation of inventory gains caused by inflation.

The effects of both legislated and inflation-induced tax changes can be clearly seen in the table. In 1953 the average corporate tax rate exceeded the statutory rate. Since the inflation rate in that year was below 1 percent, this must be due to the use of straight-line depreciation that was less generous than the economic depreciation estimated for the national income accounts. With the 1954 legislation, average tax rates fell below 52 percent. The gap widened further with the introduction of the investment tax credit in 1962. As inflation increased in the late 1960s, the gap narrowed again, increasing with the additional tax incentives of 1971 and 1975 and decreasing in years of serious inflation such as 1974. Except for the initial drop in the early 1950s and the recent decline caused by the 1981 and 1982 legislation, there is no obvious trend in average corporate tax rates during the period.

There are two factors that reconcile these results with the declining revenues shown in table 1. First, the increase in nominal interest rates during the 1970s, combined with a relatively stable aggregate corporate debt-equity ratio, decreased measured corporate profits as a fraction of GNP.[6] Second, even with interest payments added back in, there is evidence that the total return to corporate capital declined during the 1970s.[7] Neither of these factors necessarily indicates a lessening of the impact of the corporate tax on behavior, as discussed below.

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[5] Estimates of the inflation-induced tax payments at the individual level are presented in Feldstein and Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector."

The Recent Tax Acts

The Economic Recovery Tax Act of 1981 substantially reduced the corporate tax burden by replacing the system of numerous asset depreciation classes with three "capital recovery" classes. Light equipment can be written off over three years, other equipment over five years, and business structures over fifteen years. The associated reduction in taxes was mitigated by the passage of the Tax Equity and Fiscal Responsibility Act of 1982, which repealed accelerations in the write-off pattern that were to have occurred in 1985 and 1986 and instituted a basis adjustment of 50 percent for the investment tax credit. That is, investors receiving the 10 percent investment tax credit now receive depreciation deductions on a base of 95 cents per dollar of capital purchased.[8] Another important change brought about by the 1982 act was the reduction and eventual repeal of the "safe-harbor leasing" mechanism introduced by the 1981 act to facilitate the transfer of tax deductions and credits from one company (typically not with positive taxable income) to another. This last change is discussed in greater detail below.

The estimated net impact of the 1981 and 1982 acts on corporate tax revenues is evident in tables 1 and 2. As a percent of GNP, corporate

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6. For more detail on this debt-equity ratio see Roger H. Gordon and Burton G. Malkiel, "Corporation Finance," in Henry J. Aaron and Joseph A. Pechman, eds., *How Taxes Affect Economic Behavior* (Brookings Institution, 1981), pp. 131–96.

7. This point is the subject of some dispute. Although Martin Feldstein and Lawrence Summers, "Is the Rate of Profit Falling?" *BPEA, 1:1977*, pp. 211–28, argue that observed declines were primarily cyclical, recent evidence presented in Barry Bosworth, "Capital Formation and Economic Policy," *BPEA, 2:1982*, pp. 273–317, makes a compelling case for a secular decline in the rate of return to capital.

8. These changes are described in more detail in Auerbach, "The New Economics of Accelerated Depreciation."

tax collections fell by approximately 40 percent from 1980 to 1982, and the average corporate tax rate fell to a new low in 1982.

Identifying the Appropriate Marginal Tax Rate

Many authors have used average tax rates such as those in table 1 or related measures incorporating interest payments and personal taxes to determine the impact of the corporate tax on the incentive to invest.[9] For several important reasons, however, such measures may fail to capture changes in the marginal tax rate on income from new capital investment.

RETURNS TO NONCAPITAL FACTORS

Corporations receive income in excess of a competitive return to capital. The sources of such income may include but are not limited to the entrepreneurial ability of management and the exercise of market power. Because such income does not come from depreciable capital that benefits from accelerated depreciation allowances, nor does it qualify for an investment tax credit, it faces an effective tax rate equal to 46 percent. Such taxation is not directly relevant to the incentive to invest in fixed capital, but is incorporated in measured average tax rates.

RETURNS TO OLD CAPITAL

Even when the tax law is not changed over time (by legislation or inflation), assets of different vintages face different tax rates in a given year on the income they generate. This is easily illustrated by considering equipment purchased under the 1981 tax law. After five years, the equipment receives no depreciation allowances—its gross rents are fully taxed. In the year of its purchase, the equipment received not only a substantial depreciation allowance (15 percent) but also a 10 percent investment tax credit.[10] Because of the acceleration of depreciation allowances relative to actual depreciation, taxable income is lower in the early years of the asset's life and higher in the later years than a true measure of income. Assets face higher taxes on the income they generate in later years relative to earlier years. Since a capital investment generates income over many years, these tax rates must be combined in some useful way to derive the overall impact of taxation on that investment. Simple averaging of tax rates over vintages of assets in a given year does not give the correct answer: as a result of changes in the tax code, assets of older vintages are currently being depreciated under tax rules that do not apply to new investment; there is no reason for the relative quantities of capital by vintage to correspond to the relative incomes, which differ at different ages for a given vintage; and simple averaging ignores discounting. I return to this subject below to show how the appropriate calculation can be done.

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[9] See, for example, Feldstein and Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector."

[10] The 15 percent allowance corresponds to half of the first year of depreciation permitted a five-year asset under the 150 percent declining balance formula. The so-called half-year convention built into the 1981 formulas gives assets a half year of allowances during the first year, irrespective of purchase date.

ANTICIPATED CHANGES IN THE TAX CODE

It does not require strong assumptions about rational expectations to conclude that investors may anticipate future changes in the tax law. Sometimes these changes are embodied in legislation already in place. Such was the case in 1981, when increases in the generosity of depreciation schedules were to take place in 1985 and 1986.[11] Since existing assets generally cannot be converted to the new schedules, anticipated tax incentives can represent an implicit tax on current investment. This has long been recognized but is not accounted for in the computation of average annual tax rates.

ASYMMETRIES IN THE TREATMENT OF GAINS AND LOSSES

The tax code imposes essentially two corporate tax rates: 46 percent on positive taxable income and zero on negative taxable income. If a firm incurs a tax loss, it has two alternatives. If sufficient taxes were paid during the previous three tax years, the current tax loss may be "carried back" and used to offset previous taxable income, with a resulting tax refund equal to 46 percent of the current loss. To this extent, current losses do receive the same treatment as gains. If, however, the current loss exceeds the previous three years' taxable income, the excess must be "carried forward," with the hope that future income will be sufficient to absorb it. Since losses carried forward do not accrue interest, they decline in present value at the nominal interest rate. The current limitation to carrying forward is fifteen years, increased from seven years by the 1981 act.

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[11] Because such changes were repealed in 1982, fully rational investors might have anticipated this in 1981 and expected no change to occur in 1985 and 1986.

This feature of the tax code affects new investment in two ways. First, firms currently carrying losses forward face a different pattern of expected deductions, credits, and taxable income than do firms currently taxable. Second, even taxable firms face the possibility of being nontaxable, and therefore losing the value of tax deductions, at some future date.

The motivation behind this feature of the law may in part be protection against fraudulent losses produced by fictitious companies and "hobby" losses in which consumption expenditures are characterized by the taxpayer as business expenses. That the absence of tax deductibility was perceived as a problem for legitimate businesses became evident when the 1981 act included a provision making it easier for firms to transfer tax benefits to other firms through the guise of leasing. The complicated impact of the asymmetry of the taxes on losses and gains cannot be captured by aggregate average tax rates. Different firms could face enormously different marginal tax rates on the same new investment because of differences in their current or anticipated status with regard to taxable income.

RISK

Average tax rates for the corporate sector are calculated by comparing taxes to earnings, but these may have different risk characteristics. Corporate earnings are extremely volatile, while depreciation allowances are known with a fair amount of certainty, at least in nominal terms. The extent to which measured ex post tax rates accurately reflect the real burden imposed by the tax system ex ante has been the subject of much recent discussion.

In the remaining sections of this paper I explore the impact of these factors. I begin by temporarily setting aside the questions of tax losses and risk and consider what has happened over the past thirty years to the marginal tax rates for corporations on equity-financed investments in several classes of assets. The results enable one to compute not only aggregate marginal tax rates but also those faced by different industries. The differing incentives faced by these industries to invest in various assets result in a production distortion, which is estimated using the calculated tax-rate series.

In succeeding sections, I analyze how these basic results are affected by a more realistic treatment of risk and the asymmetric tax treatment of gains and losses and how, in the presence of personal taxes and the corporate financial decision, inflation affects the incentive to invest. Finally, an estimate is made of the extent to which accelerated depreciation has led to a reduction in the market value of corporate capital, relative to its replacement cost, as a result of the deferred taxes faced by older assets. This phenomenon is important not only when interpreting trends in corporate tax receipts but also in the evaluation of tax reform proposals that would alter the relative treatment of old and new assets.

Measuring Effective Tax Rates on Corporate Capital

In this section the focus is on the problem of determining marginal tax rates on prospective investments. The procedure is to use information on the actual composition of business fixed investment in the United States, estimated economic depreciation rates, and the tax law in each year, to derive the effective tax rates faced by individual investments in each year. These can then be aggregated to obtain overall effective tax rates. Because the focus is on fixed capital, the problem posed by the existence of noncapital income on corporate returns is eliminated. Because each vintage of assets is considered independently, the problem of aggregating vintage does not occur. The calculations assume that the relative price of capital goods and the tax rate are constant. The assumption that future tax changes are zero or are not anticipated has been the standard assumption in many related studies, so the calculations here are comparable to those of others.[12]

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[12] Studies that have calculated effective tax rates using this methodology include Charles Hulten and James Robertson, "Corporate Tax Policy and Economic Growth: An Analysis of the 1981 and 1982 Tax Acts" (Washington, D.C.: Urban Institute, 1982), and Mervyn King and Don Fullerton, eds., *The Taxation of Income from Capital: A Compar-*

The basic formula used in these calculations is the well-known Hall-Jorgenson user cost of capital, which gives the cost of a unit of capital services (under the assumption that the tax law will remain fixed) as:

$$c = q(r + \delta)(1 - k - uz)/(1 - u), \tag{1}$$

where

q = relative price of capital goods
r = real rate of return the firm must earn after corporate taxes
δ = exponential rate at which the capital good decays
k = investment tax credit
u = corporate tax rate and
z = present value of depreciation allowances obtained by discounting nominal depreciation allowances at $r + \pi$, the nominal rate, where π is the inflation rate.

Equation 1 implicitly assumes the use of equity finance, for if debt finance were used, r itself would depend on the tax rate u because of the deductibility of interest payments. If one introduces b, the fraction of the investment a firm finances with debt, at a nominal interest rate, i, and denotes the required nominal return to equity holders by e, it can be shown that[13]

$$r = bi(1 - u) + (1 - b)e - \pi. \tag{2}$$

At the margin, the firm earns zero profits after tax, in present value, if it invests until the marginal product of capital equals c. The effective corporate tax rate can be defined by asking what rate of tax, τ, on the corporation's true economic income would present the same incentive to invest, for a given rate r and the actual combination of u, k, and z. Under a pure income tax, depreciation allowances would equal economic depreciation, and the investment tax credit would equal zero. Since economic depreciation per dollar of investment equals $(1 - \delta)^t\delta$, t years after the asset's purchase, the present value of such allowances would

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ative Study of the U.S., U.K., Sweden and West Germany (National Bureau of Economic Research, forthcoming). The first of these studies, like this one, looks only at taxes at the corporate level, while the second also includes the effects of corporate interest deductibility and personal taxes.

[13] See Alan J. Auerbach, "Wealth Maximization and the Cost of Capital," *Quarterly Journal of Economics*, vol. 93 (August 1979), pp. 433–46.

be $\delta/(r + \delta)$, and hence τ would be defined implicitly by the expression

$$c = q\left(\frac{r}{1 - \tau} + \delta\right), \tag{3}$$

where c is defined as in equation 1. Combining 1 and 3 yields the solution for τ,

$$\tau = \frac{c/q - (r + \delta)}{c/q - \delta} = \frac{(r + \delta)(1 - k - uz) - (r + \delta)(1 - u)}{(r + \delta)(1 - k - uz) - \delta\,(1 - u)}. \tag{4}$$

Equation 4 is applied to historical data to determine the effective tax rates over time. The data come from various empirical sources and assumptions. For each asset, it is assumed that the depreciation practice followed was the most advantageous available to the investor in the year of investment. This rules out the use of straight-line depreciation in a year when, say, double-declining balance depreciation was available. Although there is evidence that not all businesses immediately switch to newly provided accelerated depreciation options, incorporating such behavior in the calculations is difficult without a more general model capable of explaining it.[14] The detailed assumptions, depreciation methods, and lifetimes are discussed in appendix A. The asset categories are those for nonresidential investment used in national income account calculations. The real economic depreciation rate, δ, used for each asset category comes from calculations based on patterns of price declines in asset resale markets.[15]

To calculate τ one also needs to know the real discount rate, r, and the inflation rate, π. Future values of π needed for the calculations of z are set equal in each year to those predicted from an ARIMA forecast based on lagged values of the inflation rate. Somewhat arbitrarily, *r* is set at 4 percent.

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[14] For evidence see Terence J. Wales, "Estimation of an Accelerated Depreciation Learning Function," *Journal of American Statistical Association*, vol. 61 (December 1966), pp. 995–1009; and Thomas Vasquez, "The Effects of the Asset Depreciation Range System on Depreciation Practices," Paper 1 (U.S. Treasury, Office of Tax Analysis, May 1974).

[15] These depreciation rates are presented in Dale W. Jorgenson and Martin A. Sullivan, "Inflation and Corporate Capital Recovery," in Charles R. Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital* (Washington, D.C.: Urban Institute, 1981), pp. 171–237. Most of the depreciation rates were originally calculated and presented by Charles R. Hulten and Frank C. Wykoff, "The Measurement of Economic Depreciation," in Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital*, pp. 81–125.

Shown in table 3 are the thirty-four asset categories for which effective tax rates are calculated, along with their estimated rates of economic depreciation. Table 4 shows the historical series for the effective tax rates for two representative assets, industrial equipment and structures, in addition to the total annual rates, derived by weighting according to the composition of the capital stock.

Table 4 clearly shows the effects of both legislated tax changes and inflation. During the 1976–78 period, for example, there were no changes in the tax law. However, as inflation declined and then increased, so did effective tax rates. The same effect is evident between 1979 and 1980. The general results are consistent with time-series estimates of the type done by Hulten and Robertson.[16] Even before 1981 the net effects of inflation and the tax law had been to keep tax rates during the 1970s, overall, at levels comparable to (or lower than) those in the mid-1960s. Adding the 1950s and the period from 1981 to 1982 leads to an overall picture of declining rates, a trend that is weaker than the decline in revenues in table 1 but stronger than that of the average effective tax rates in table 2, which are comparable in ignoring interest deductibility. This demonstrates the importance of looking at marginal tax rates.

The overall trend in aggregate tax rates masks a very strong shift between structures and equipment that is typified by the two assets in table 4. From 1953 through 1961 structures were relatively favored. Since then, almost all tax incentives have been aimed at equipment; the widening gap in effective tax rates was curbed somewhat in 1982, when the partial basis adjustment for the investment tax credit was introduced. This also served to remove, for the most part, the negative tax rates enjoyed by equipment in general. This possibility of negative tax rates merely reflects the fact that tax incentives can be so great as to lead investors to require a lower return before tax than after tax.

Effective tax rates by industry also have varied substantially over the years. The 1982 values for each of forty-four corporate industries are shown in table 5. The rates range from a maximum of 39.4 percent to a minimum of 6.3 percent. The importance of such interindustry distortions is discussed below.

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[16] Hulten and Robertson, "Corporate Tax Policy and Economic Growth."

Table 3. Asset Categories and Depreciation Rates
Percent

Category number	*Asset category*	*Depreciation rate*	*Percentage of 1978 corporate investment*
1.	Furniture and fixtures	11.00	2.7
2.	Fabricated metal products	9.17	1.7
3.	Engines and turbines	7.86	0.7
4.	Tractors	16.33	1.5
5.	Agricultural machinery	9.71	0.2
6.	Construction machinery	17.22	3.3
7.	Mining and oil field machinery	16.50	1.2
8.	Metalworking machinery	12.25	3.5
9.	Special industry machinery	10.31	2.9
10.	General industrial equipment	12.25	4.1
11.	Office, computing, and accounting machinery	27.29	4.7
12.	Service industry machinery	16.50	1.8
13.	Electrical machinery	11.79	10.4
14.	Trucks, buses, and trailers	25.37	11.9
15.	Automobiles	33.33	4.8
16.	Aircraft	18.33	1.7
17.	Ships and boats	7.50	0.8
18.	Railroad equipment	6.60	1.7
19.	Instruments	15.00	4.5
20.	Other equipment	15.00	1.5
21.	Industrial buildings	3.61	6.3
22.	Commercial buildings	2.47	7.3
23.	Religious buildings	1.88	0.0
24.	Educational buildings	1.88	0.0
25.	Hospital buildings	2.33	0.1
26.	Other nonfarm buildings	4.54	0.4
27.	Railroads	1.76	0.5
28.	Telephone and telegraph facilities	3.33	2.8
29.	Electric light and power	3.00	7.1
30.	Gas	3.00	1.1
31.	Other public utilities	4.50	0.3
32.	Farm	2.37	0.1
33.	Mining, exploration, shafts, and wells	5.63	6.1
34.	Other nonbuilding facilities	2.90	0.5

Source: Dale W. Jorgensen and Martin A. Sullivan, "Inflation and Corporate Capital Recovery," in Charles R. Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital* (Washington, D.C.: Urban Institute, 1981), p. 179.

Table 4. Effective Tax Rates for Equipment and Structures, 1953–82
Percent

Year	*General industrial equipment*	*Industrial structures*	*All assets*
1953	64.1	55.6	58.8
1954	61.0	52.3	55.5
1955	58.2	50.6	53.5
1956	59.3	51.3	54.3
1957	60.2	51.9	55.0
1958	60.9	52.3	55.6
1959	59.7	51.5	54.6
1960	60.4	52.0	55.1
1961	58.8	51.0	53.9
1962	40.3	49.1	43.3
1963	41.5	49.6	44.0
1964	27.4	47.1	37.2
1965	26.1	45.5	35.7
1966	27.4	45.8	36.5
1967	49.4	46.6	45.5
1968	37.0	51.5	43.5
1969	41.0	52.7	45.8
1970	53.5	52.0	49.7
1971	53.2	51.2	49.1
1972	16.4	51.2	32.9
1973	14.4	50.9	31.8
1974	18.3	51.5	33.9
1975	24.1	52.6	37.0
1976	26.4	53.1	35.1
1977	21.2	52.1	32.0
1978	23.2	52.4	33.2
1979	19.0	50.3	30.1
1980	22.0	50.8	31.9
1981	−6.8	41.7	17.7
1982	8.4	42.1	24.6

Source: Author's calculations as discussed in the text.

The Distortionary Impact of Differential Corporate Taxation

One of the impressive facts about the effective tax rates in table 4 is how much, in any given year, they vary across investments. Since the seminal work of Harberger, there has been much concern about the

Table 5. Effective Tax Rates, by Industry, 1982
Percent

Industry number	*Category*	*Tax rate*
1.	Food and kindred products	27.0
2.	Tobacco manufactures	24.3
3.	Textile mill products	22.8
4.	Apparel and other fabricated textile products	25.3
5.	Paper and allied products	18.3
6.	Printing, publishing, and allied industries	28.1
7.	Chemicals and allied products	20.1
8.	Petroleum and coal products	33.2
9.	Rubber and miscellaneous plastic products	19.8
10.	Leather and leather products	27.4
11.	Lumber and wood products, except furniture	25.3
12.	Furniture and fixtures	28.6
13.	Stone, clay, and glass products	24.6
14.	Primary metal industries	26.0
15.	Fabricated metal industries	23.3
16.	Machinery except electrical	24.6
17.	Electrical machinery, equipment, and supplies	24.7
18.	Transportation equipment, except motor vehicles and ordnance	30.4
19.	Motor vehicles, and motor vehicle equipment	21.3
20.	Professional photographic equipment and watches	27.0
21.	Miscellaneous manufacturing industries	25.8
22.	Agricultural production	16.8
23.	Agricultural services, horticultural services, forestry and fisheries	14.7
24.	Metal mining	34.3
25.	Coal mining	19.1
26.	Crude petroleum and natural gas extraction	32.2
27.	Nonmetallic mining and quarrying, except fuel	15.6
28.	Construction	13.1
29.	Railroads and railway express service	21.4
30.	Street railway, bus lines, and taxicab service	10.0
31.	Trucking service, warehousing, and storage	14.7
32.	Water transportation	6.3
33.	Air transportation	11.5
34.	Pipelines, except natural gas	22.9
35.	Services incidental to transportation	17.1
36.	Telephone, telegraph, and miscellaneous communication services	19.7
37.	Radio broadcasting and television	25.8
38.	Electric utilities	25.0
39.	Gas utilities	20.0
40.	Water supply, sanitary services, and other utilities	39.4
41.	Wholesale trade	18.7
42.	Retail trade	27.5
43.	Finance, insurance, and real estate	37.3
44.	Services	23.9

Source: Author's calculations. Tax rates for other years are available from the author upon request.

losses caused by the misallocation of capital between the corporate and noncorporate sectors, particularly housing.[17] Relatively less emphasis has been placed until recently on the massive distortions across industries, and within any given industry in the corporate sector. In part because of the complex way in which personal taxes interact with corporate taxes (discussed below), it is not clear that corporate investment faces a substantially higher overall tax rate than noncorporate investment. Thus distortions within the corporate sector may be as important as distortions between that sector and other sectors, and reform of the corporate tax should recognize this.

Little empirical work has been done on the losses due to differential taxation within the corporate sector. This is not surprising, given that it would require knowledge of elasticities of substitution among different types of capital and labor in production in each corporate industry, about which there is very little evidence. To provide some insight into this question, therefore, I examine the losses imposed by the corporate tax under what have come to be fairly standard "baseline" assumptions: that each industry has a production function that is Cobb-Douglas in each type of capital used and labor, and that capital is allocated so as to equate the real after-tax return across investments. This latter assumption makes it appropriate to regard the losses as long run. Under these assumptions it is possible to derive an analytic expression for and compute the loss; in particular, for the vector of outputs being produced by the corporate sector, one can calculate how much of the existing capital stock could be disposed of if the remaining capital were allocated optimally.

The analytic expression for this measure of the welfare cost of differential corporate taxation is derived in appendix B. It contains two components, each of which is nonnegative. The first, which expresses the distortion due to differential taxation *within* industries, is zero only when there is uniform taxation within each industry. The second, which expresses the distortion due to differential taxation *between* industries, is zero only when the weighted geometric means of the before-tax rates of return in each industry are the same. The measure derived here is related to that obtained by Gravelle, who also used the Cobb-Douglas assumption but aggregated the corporate sector into a single industry.[18]

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[17] Arnold C. Harberger, "Efficiency Effects of Taxes on Income from Capital," in Marian Krzyzaniak, ed., *Effects of the Corporation Income Tax* (Wayne State University Press, 1966), pp. 107–17.

When this technique is used to determine the asset-specific effective tax rates, it yields the series in table 6 for the fraction of the capital stock effectively wasted under the long-run allocation of capital according to the effective tax rates prevailing in a given year.

These distortions show no downward trend, despite the steady decline in corporate tax collections. On the contrary, the overall loss has exceeded 1.54 percent since 1972, whereas it was never as high before. The two components of the total distortion have generally moved together, with the "within" component accounting for about four-fifths of the distortion. Major increases in the degree of distortion occurred in 1964, with the repeal of the Long Amendment, and in 1971, with the introduction of the Asset Depreciation Range. A smaller increase was associated with the 1981 legislation, while the basis adjustment instituted in 1982 substantially lowered the estimated distortion. The 1981 distortion implies, for instance, that 3.19 percent of the 1981 net corporate capital stock of 2.05 trillion dollars was being wasted in that year.[19] At a before-tax return of 8 percent, this would mean a loss of over $5 billion in 1981. It should be emphasized that this measure does not take into account the change in *mix* of outputs within the corporate sector and the relative levels of production in the corporate and noncorporate sectors that could be expected to flow from the tax inequalities. Such changes would increase the welfare loss.

Tax Losses under the Corporate Tax

Over the years, as depreciation schedules have become more accelerated, more firms have found themselves without taxable income against

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[18] Jane G. Gravelle, "The Social Cost of Nonneutral Taxation: Estimates for Nonresidential Capital," in Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital*, pp. 239–50. Her measure also differs in the use of a Cobb-Douglas function for gross rather than net output. Although the former approach may be conceptually more appealing, only the latter allows a closed-form solution in the multi-industry case. This difference helps explain why the estimate of excess burden in this paper is somewhat higher for 1981: the elasticity of substitution is higher when the net Cobb-Douglas function is used.

[19] John C. Musgrave, "Fixed Reproducible Tangible Wealth in the United States," *Survey of Current Business*, vol. 62 (October 1982), pp. 33–38.

Table 6. The Welfare Cost of Differential Corporate Taxation, 1953–82
Percent of capital stock

Year	*Distortion within industries*	*Distortion between industries*	*Total distortion*
1953	0.59	0.13	0.72
1954	0.53	0.11	0.64
1955	0.37	0.07	0.45
1956	0.43	0.09	0.52
1957	0.48	0.10	0.58
1958	0.51	0.11	0.62
1959	0.45	0.09	0.54
1960	0.49	0.10	0.59
1961	0.40	0.08	0.48
1962	0.45	0.12	0.57
1963	0.41	0.11	0.52
1964	1.11	0.29	1.40
1965	1.01	0.26	1.27
1966	0.94	0.24	1.18
1967	0.25	0.04	0.29
1968	0.82	0.21	1.03
1969	0.62	0.16	0.78
1970	0.27	0.05	0.33
1971	0.27	0.05	0.32
1972	2.95	0.69	3.64
1973	3.17	0.74	3.90
1974	2.74	0.64	3.38
1975	2.18	0.50	2.69
1976	2.13	0.57	2.70
1977	2.69	0.71	3.40
1978	2.40	0.64	3.04
1979	2.52	0.67	3.19
1980	2.23	0.59	2.83
1981	2.64	0.55	3.19
1982	1.29	0.25	1.54

Source: Author's calculations as described in appendix B.

which to claim deductions. This is easy to understand. Under the current tax law, an investor purchasing an asset in the five-year capital recovery class receives an immediate deduction of 15 percent, a deduction of 22 percent after one year (both on a basis equal to 95 percent of purchase price), and an immediate investment tax credit. Gross receipts in the first year of at least 56.9 cents per invested dollar, that is, $(15 + 22) \times 0.95 + 10/0.46$, would be required to absorb these tax benefits, even without accounting for the fact that investment credits cannot be used to offset all taxable income. Firms without substantial existing sources of income and fast-growing firms are likely to have to carry losses back or forward. Carrying losses forward, however, essentially offsets the benefits of accelerated depreciation. This problem provided an impetus for the introduction of "safe-harbor" leasing under the 1981 tax act. To understand why this process was structured as it was and also why it was so unpopular, it helps to review why the current tax system discriminates against tax losses.

Aside from the enforcement problems mentioned above, the lack of a loss offset in the tax system possibly derives in part from a perception among policymakers that losing firms are just that: "losers." For some reasons, the stockholders of such firms are unable to replace poor management or, for some other reason, the helping hand of government is necessary to discourage such firms. The benefit of having carry-back and carry-forward provisions, so this argument continues, is that successful, risk-taking firms with an occasional "bad draw" would lose little or nothing, while those with more permanent problems would benefit less from these provisions.

Aside from the questionable economic merit in discriminating among firms by the state of their income, there are at least two additional problems with this approach. First, even if "losers" are initially discouraged from investing because of the prospect of nonrefundable losses, once these losses have occurred, the desire to use them up through carrying forward may offer an increased incentive to invest in the future in order to generate higher expected taxable income. Second, under a tax that does not have economic income as its base, there need be no systematic relation between a firm's taxable income and its underlying profitability. Indeed, under accelerated depreciation it is the firms whose capital stocks are growing fast that face the severest problem.[20]

"SAFE-HARBOR" LEASING AS A SOLUTION

For years before 1981, leasing was recognized as a method for transferring tax benefits among firms. That many airlines leased some or all of their planes from financial institutions was well known. By making payments to the lessor over the period of the lease timed to coincide better with the income from the project, the lessee could obtain a greater part of the value of the tax benefits, which would be transferred by the lessor in the form of reduced lease payments.

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[20] These issues are explored more fully in Alan J. Auerbach, "The Dynamic Effects of Tax Law Asymmetries," Working Paper 1152 (National Bureau of Economic Research, June 1983).

But leasing could only be used for certain assets, essentially those that could be used by a firm other than the lessee at the expiration of the lease: planes, but not dies used to make cars of a particular model. Moreover, there were other provisions that prohibited lessee finance or a fixed repurchase price option and required a "reasonable" profit for the lessor before tax, which made leases imperfect as a transfer mechanism.

Most of these hindrances were removed in 1981, and the result was a spate of "wash leases" under which cash changed hands only at the initiation of a lease, and the title to the asset in question never left the possession of the user. In this arrangement, the purchaser of the tax benefits (the lessor) received the investment tax credit and depreciation deductions in exchange for this initial "down payment," plus a stream of future tax liabilities. The transaction involved a paper loan by the lessee to make up the difference between the down payment and the full price of the asset. The tax obligations of the lessor reflected the fact that the paper lease payments received exceeded the paper interest payments by an amount equal to the principal repayments made to the lessee. In addition to the down payment, the lessee received a stream of future decreases in tax liability mirroring those of the lessor.[21]

Safe-harbor leasing was criticized and scheduled under the tax act of 1982 for repeal after 1983, to be replaced by yet another type of leasing that is referred to in the legislation as finance leasing. From initial inspection, finance leasing appears to be a hybrid of safe-harbor leasing and the pre-1981 leasing, often referred to as leveraged leasing.[22] Much of the criticism took the form of declamations against "welfare for corporations," reflecting in part news stories relating the success of firms like General Electric Company in using leases to offset its current income tax liability as well as those of *previous* years (through a carry-back) and Occidental Petroleum Corporation's use of leasing to enable it to use foreign tax credits that otherwise would have expired. But perhaps the more fundamental problem with leasing was that it did not appropriately discriminate among investors.

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[21] Leasing is described more fully and a sample wash lease outlined in Auerbach, "The New Economics of Accelerated Depreciation."

[22] The 1982 changes are discussed and analyzed in Alvin C. Warren, Jr., and Alan J. Auerbach, "Tax Policy and Equipment Leasing after TEFRA," *Harvard Law Review*, vol. 96 (May 1983), pp. 1579–98.

To understand this problem, it is helpful to define three extreme types of investor: the company with taxable profits now and for the forseeable future (the taxable company), the company with a substantial current tax loss being carried forward and little prospect for being taxable in the future (the tax-exempt company), and the company undertaking large initial investments that generate large current deductions and credits that cannot be used, but with the prospect of taxable income in the near future (the start-up company).[23] First, consider the case in which no deductions are generated by the use of debt finance.

Under the Accelerated Cost Recovery System, the taxable investor purchasing an asset in the five-year capital recovery class in 1981 obtained, in effect, a negative tax rate on that asset: as shown in table 4, the present value of the investment tax credit and depreciation allowances from that cost recovery system slightly exceeded those that would have been available if immediate expensing were allowed for tax purposes. For the start-up firm, however, this was not the case. By having to carry forward unused credits and deductions, the benefits of acceleration were lost. By engaging in a lease, the start-up company could receive the full benefits, through the immediate down payment and the future tax deductions, timed to occur after the company had become taxable. But tax-exempt firms could engage in leases, too, and did so. Because such firms were facing roughly the same incentives to invest as the taxable firms, the receipt of the initial down payment appeared to provide them with a substantial benefit. Given down payments under five-year leases in the neighborhood of 20 cents per dollar of investment, this was an important issue.

Once debt finance is taken into account, however, these results are altered. In particular, the tax-exempt firms face the additional disadvantage of not being able to deduct interest payments. Calculations by Warren and Auerbach suggest that, for firms using all debt finance at the margin, leasing as structured under the 1981 act would have been inadequate to reduce the user cost of capital to that of the taxable corporation.[24]

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[23] The following discussion draws on the arguments in Alvin C. Warren, Jr., and Alan J. Auerbach, "Transferability of Tax Incentives and the Fiction of Safe Harbor Leasing," *Harvard Law Review*, vol. 95 (June 1982), pp. 1752–86.

THE IMPACT OF LOSSES ON THE INCENTIVE TO INVEST

These taxable, start-up, and tax-exempt companies are extreme cases that exist only in papers such as this. In reality, each firm has a finite probability of being taxable in a particular year in the future, given its current and past experience. The discussion in this section seeks to determine how large an effect this has on the incentive to invest. The basic approach involves observing individual firms over time and estimating the probabilities of whether a firm will be taxable in a given year based on the experience of previous years, assuming the firm optimizes subject to a particular tax system. With such estimates, one can obtain the expected present value of taxes the firm will pay in connection with a new investment project, by translating the accrued tax liability (positive or negative) that the project generates in each year into a distribution of dates over which those taxes actually will be paid. Because I limit consideration to marginal projects that are assumed not to affect the firm's probabilities of being in a particular taxable position in a given year, this is a straightforward calculation. The calculations are based on observations of the tax loss carried forward by individual firms over time, inasmuch as data on annual accrued tax liabilities are not currently available.

Under current tax law, a firm with a tax loss may obtain a refund for this loss and hence be taxed as if there were a full-loss offset at the margin if the nominal value of its previous three years' taxable income is at least as large. Such losses are said to be carried back against previous income. A firm that has insufficient potential for carrying back can only carry excess current losses forward, in the hope that its nominal value can be offset against future taxable income. Losses can now be carried forward for as many as fifteen years; before 1981 they expired after seven years.

One may think of current taxable profits in a symmetric way. If, for example, the firm has a larger loss carried forward from previous years, the profits are set against the loss carried forward; the firm pays no taxes and carries forward any remaining loss to the next year. If the firm has a potential for loss carry-back in the form of previously taxed income, it pays taxes on its current income and adds it to the potential carry-back that it has available in the following year.

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[24] Ibid.

One may summarize the firm's current tax status by a continuous variable, y_t, equal to the real value of its tax loss carry-forward at the end of year t when positive and, in absolute value, equal to the firm's potential loss carry-back when negative. Whether increments to a given year's tax liabilities are paid in year t or some later year depends on the sign of y_t. If y_t is negative, whatever additional taxes (positive or negative) the firm owes are paid in year t. If y_t is positive, the firm neither receives additional benefits nor pays incremental taxes at the margin in year t. The additional liability (perhaps negative) is added to the previous loss carry-forward and is to be paid (in fixed nominal terms) in the first subsequent year when y_t is negative. To calculate the expected present value of a particular dated tax liability one must therefore know the joint distribution of y_t and its past and future values.

The modeling of y_t is complicated because its relation to its own past values depends both on the tax law and the characteristics of the firm. One would expect substantial serial correlation in y_t because the current year's taxable income or loss is likely to be small relative to the stock of losses carried forward or gains available for a potential carry-back. However, y would tend to decay even with a zero current tax liability, for two reasons. First, since an unused carry-forward (or carry-back) is a nominal claim, its real value decays at the rate of inflation. Moreover, the expiration of carry-forwards and potential carry-backs imparts a further, vintage-related decay of y.

To the extent that a firm would normally expect positive taxable income in a given year, this will tend to lead over time to negative y_t. The evolution of y_t, starting at any initial value, depends not only on the tax law (with respect to depreciation allowances and so on) but also on the firm's overall level of profitability and the stochastic process generating its annual returns. Firms facing a loss carry-forward may alter their behavior to influence y because the accrual of losses over time without interest provides an incentive to "use them up."[25]

Because even a simple specification of the evolution of y leads to a fairly complicated procedure for the derivation of the conditional probabilities needed for these calculations, I assume that all the effects just mentioned can be summarized by the first-order process,

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[25] This is discussed in Auerbach, "The Dynamic Effects of Tax Law Asymmetries."

$$y_t = \alpha + \beta y_{t-1} + \epsilon_t, \tag{5}$$

where the tax loss carry-forward, y_t, is divided by a measure of the firm's assets to correct for potential heteroscedasticity. I use the estimated variance of ϵ_t along with the estimates of α and β to generate distributions for y_t, conditional on its past value, under the assumption of normality. Using the estimated distribution of y_t conditional on y_{t-1}, that of y_{t-1} on y_{t-2}, and so forth, I can then generate the conditional probability that y_t exceeds zero, given information on whether each of $y_{t-1}, y_{t-2}, \ldots$ exceeded zero. The distribution of actual tax payments deriving from a tax liability, T_t, dated year t then equals ${}_tp_0 \times T_t$ in year t, ${}_{t+1}p_{10} \times T_t(1 - \pi_{t+1})$ in year $t + 1$, ${}_{t+2}p_{110} \times T_t(1 - \pi_{t+1})(1 - \pi_{t+2})$ in year $t + 2$, and so on, where ${}_tp_0$ is the unconditional probability of being taxable in year t, π_t is the inflation rate in year t, and ${}_{t+i}p_{1,\ldots 10}$ is the probability that $y_{t+i} < 0$, conditional on $y_t, y_{t+i}, \ldots, y_{t+i-1} > 0$. With a perfect loss offset, ${}_tp_0$ would equal 1, and the remaining probabilities would equal zero. Calculation of the time it takes for the probabilities $p_0, p_{10}, \ldots$ to converge to zero provides an estimate of how long a firm with a loss takes to pay its accrued taxes.

To estimate equation 5, I used the Compustat data file derived from a panel of large American corporations. The version of Compustat used contains data from 1959 to 1978. It is unfortunate that the variable y, which is defined here to be the tax loss carry-forward when positive and the potential carry-back when negative, is observed only when it is positive. That is, Compustat contains an annual observation for each firm on the tax loss carry-forward but nothing on the potential carry-back. Construction of such a number would require information on the previous three years' taxable income, which is unavailable. Thus for many observations y_t, y_{t-1}, or both, are missing.

To obtain consistent estimates of α and β, the following technique is adopted. All observations for which y_{t-1} is observed are selected and, using a standard Tobit procedure, equation 5 is estimated. From this, one can obtain predicted values of y_t for all these observations, including those for which the actual value is not available. Adding observations on y_{t+1}, for which a predicted value of y_t can now be used as the explanatory variable, I reestimated equation 5.[26] For the first stage of the estimation 1,750 observations were available for 1959–77, with most occurring in the latter part of the sample. By the method just described, another 317 observations were added for the second stage of the estimation. The resulting equation is[27]

$$y_t = -\underset{(0.009)}{0.063} + \underset{(0.023)}{0.729}\, y_{t-1} \tag{6}$$

$$\text{Standard error of estimate} = 0.348,$$

where standard errors are in parentheses, and y_t (when positive and observed) equals the firm's tax loss carry-forward divided by a corrected measure of its net capital stock.[28] The coefficients α and β conform to prior expectations that the former should be negative and the latter between zero and 1. This combination yields a long-run value of y_t that is negative and the decay of shocks away from it. The long-run value of y_t implied by 6 is -0.232; the typical firm would have available a potential carry-back equal to 23.2 percent of its net capital stock. Given observed before-tax rates of return, this represents approximately two years of profit, a reasonable figure.

This long-run value, however, is simply the mean of a long-run distribution of y_t. It is the value to which y_t would converge in the absence of shocks of above-average losses or gains. In fact, there will be a long-run probability distribution for y_t around this value that depends on the magnitude of these shocks. By assuming that the annual random shock to y_t is normally distributed, with a standard deviation equal to the standard error of estimate in 6, one can calculate the long-run probability distribution for y_t. Using this long-run distribution, one can then calculate

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[26] The argument for doing so is that otherwise α and β will be derived only from observations for which y_{t-1} is positive. Any asymmetry in the equation connected with the sign of y_{t-1} would not be discernible. In fact, this two-stage procedure, in principle, allows estimation of individual values of α and β depending on the sign of y_{t-1}. Such an experiment proved unsuccessful, however, because the coefficients for negative values of y_{t-1} were estimated with insufficient precision.

[27] Because the two stages were estimated separately, these standard errors lack the adjustment necessary to account for the fact that some values of y_{t-1} are estimated. However, given that such observations are a small part of the sample, and that the standard errors are so small relative to the coefficients, such a correction was not made here.

[28] This capital-stock measure was calculated for the Compustat firms and is described by Clint Cummins, Bronwyn Hall, and Elizabeth Laderman in "The R&D Master File: Documentation," August 1982.

Table 8. Effective Tax Rates for Equipment and Structures: The Importance of Deferred Payment[a]
Percent

Tax law and inflation rate	General industrial equipment: Immediate payment $p_0 = 1$	General industrial equipment: Actual	Industrial structures: Immediate payment $p_0 = 1$	Industrial structures: Actual
1965 tax law				
No inflation	13	22	38	37
4 percent	33	37	52	47
8 percent	48	47	58	52
1972 tax law				
No inflation	8	18	40	38
4 percent	27	33	55	50
8 percent	42	43	62	55
1982 tax law				
No inflation	−13	10	27	27
4 percent	0	18	38	37
8 percent	12	25	45	42

Source: Author's calculations as described in the text.

a. Tax rates labeled $p_0 = 1$ assume that tax payment occurs when liability is accrued; those labeled actual are based on table 7, using the method described in the text.

this to the assumed before-tax return using equation 4 yields, as before, a value for τ, the effective tax rate.[29]

These rates are presented in table 8 for two representative assets, industrial structures and general industrial equipment. A before-tax real return of 6 percent is assumed, and the economic depreciation rates listed in table 3 (0.0361 and 0.1225, respectively) are used. Estimates are given of τ for the tax laws of the mid-1960s, of the early 1970s, of the present period, and for inflation rates of zero, 4, and 8 percent. Also presented are the effective tax rates, comparable to those in table 4, based on the assumption that taxes are paid when the liability is accrued.

It should be kept in mind that the estimates on which the probabilities are based come from a reduced-form equation that would not necessarily be stable over changes in tax régime or economic environment. The value of p_0, for example, will undoubtedly be lower in the 1980s because of the tax changes enacted in 1981. Thus estimates of the impact of losses for 1982 probably understate their actual importance. However, one can view the results as illustrations of the general magnitude of the effect that loss carry-forwards and carry-backs may have.

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[29] These calculations are based on a fixed before-tax return, rather than those above, which started with the after-tax return and generated a before-tax return. The difference lies only in that the overall level at which the two rates are compared will normally differ.

A second point about τ is that it implicitly assumes risk neutrality with respect to the risky tax payments. This makes sense if the risk is entirely diversifiable. Otherwise, additional corrections of the type discussed in the next section are necessary.

Table 8 contains many interesting results. First, it shows that tax rates are less sensitive to inflation once tax deferral has been taken into account. Moreover, tax deferral lowers effective tax rates for structures, but generally raises them for equipment. To understand this, it helps to consider separately the tax liabilities generated by gross rents and the benefits generated by depreciation deductions. The deferral of tax payments through losses benefits the firm, but the deferral of deductions hurts it. It is possible that either effect can dominate. The larger the depreciation allowances relative to gross income, the more likely it is that their deferral will outweigh deferral of tax payments and lead to a net increase in tax rates. In general, the lower the effective tax rate, the more likely it is that deferral will raise it. This is evident at zero inflation from a comparison of the values for the representative equipment and structure and is reinforced by the relative impact of inflation, which lowers the value of depreciation allowances an asset receives.

These calculations indicate how a typical firm will be affected by the carry-forward and carry-back provisions of the tax law in the long-run. In any year, however, each firm will have a different tax history and, in the terminology here, a different value of y_t. That firms face the same incentives in the long run should not be confused with the fact that a firm with a large loss carry-forward faces very different incentives than one with a large potential carry-back. To quantify the importance of this difference, I generated the matrices of annual loss probability distributions, one for a firm with an initial value of y_t that is one standard deviation below its long-run mean (a "high-tax" firm) and one with an initial value of y_t that is one standard deviation above its long-run mean (a "low-tax" firm). After several years the entries in each matrix converge to the steady-state probabilities shown in table 7. In the short run, however, actual history is very important.

Effective tax rates for these firms, comparable to the columns labeled actual in table 8, are shown in table 9. The striking outcome in this table is that the firms with higher recent taxable profits, which are also more likely to be taxable in the near future (the high-tax firms) face *lower*

Table 9. Effective Tax Rates: The Importance of Deferred Payment, by Taxable Status
Percent

Tax law and inflation rate	General industrial equipment		Industrial structures	
	Low tax	High tax	Low tax	High tax
1965 tax law				
No inflation	17	12	37	37
4 percent	33	30	48	48
8 percent	47	43	53	53
1972 tax law				
No inflation	12	7	40	38
4 percent	28	23	52	52
8 percent	40	35	57	57
1982 tax law				
No inflation	−3	−15	27	25
4 percent	10	−3	37	35
8 percent	20	5	42	42

Source: Author's calculations as described in the text.
a. Tax rates labeled high tax assume an initial value of y_t that is one standard deviation below long-run mean; those labeled low tax assume an initial value of y_t that is one standard deviation above mean.

effective tax rates. This is because, in the early years when the differences among firms are greatest, accelerated depreciation allowances generate tax losses, especially for equipment. Being tax exempt in these years is a hindrance, not a help.

Thus the asymmetric treatment of gains and losses under the corporate tax may lower or raise taxes for the average firm and is, under recent and current tax law, most helpful for firms with a history of taxable profits.

The Corporate Tax and Risk-Taking

One of the fundamental reasons for the existence of public corporations is to allow risks to be efficiently diversified through the stock market. Various aspects of the corporate tax law influence risk-taking. Besides the discrimination against tax losses discussed above, the absence of indexing in the tax law means that uncertain inflation makes the value of depreciation deductions and nominal inventory profits uncertain. Uncertainties about future changes in the law themselves affect current decisions. However, much of the recent discussion has focused on the role of the corporate tax in sharing the private risks of corporations by collecting more revenue when profits are high and less when they are low. The existence of this risk-sharing has been understood since the seminal work of Domar and Musgrave and of Tobin, but the implications for the effective taxation of risky assets under general systems of taxation have not been fully developed.[30]

Suppose assets are risky both in their gross yield (before depreciation and taxes) and in the rate at which they depreciate. The current tax system does not absorb a proportion of the net yield (gross yield less depreciation) but rather a proportion of the *gross* yield less a predetermined allowance for depreciation. This has the effect of lessening the risk-sharing of the tax system because fluctuations in the net return that result from variations in the depreciation rate do not alter the assets' tax liability.

In appendix [illegible] it is shown that the effective tax rate on a risky investment, defined as before to be the rate of tax on economic income that would yield the same incentive to invest as the current tax system, is

$$\tau = \frac{(y + \bar{\delta} + \alpha_\delta)(1 - k - uz) - (y + \bar{\delta} + \alpha_\delta)(1 - u)}{(y + \bar{\delta} + \alpha_\delta)(1 - k - uz) - (\bar{\delta} + \alpha_\delta)(1 - u)}, \tag{7}$$

where the real, after-tax return, r, has been replaced by the safe return, y; z is now calculated using this rate plus the inflation rate; $\bar{\delta}$ is *expected* economic depreciation; and α_δ is the component of the risk premium required by investors because of the riskiness of economic depreciation. Increases in the riskiness of depreciation, through increases in α_δ, have the same effect on the firm's decisions as increases in the expected depreciation rate itself. Hence two assets that have the same overall risk premium in the absence of taxes, expected rate of depreciation, and depreciation allowances will normally face different effective tax rates, with the asset whose depreciation provides more of the overall asset risk being at a disadvantage. For this asset, the proportional tax on gross returns is of less value in the sharing of risks because the returns are not as risky.

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[30] See Evsey D. Domar and Richard A. Musgrave, "Proportional Income Taxation and Risk-Taking," *Quarterly Journal of Economics*, vol. 58 (May 1944), pp. 388–422; and James Tobin, "Liquidity Preference as Behavior Towards Risk," *Review of Economic Studies*, vol. 25 (February 1958), pp. 65–86.

Table 10. Taxation and Risk: The Impact of Stochastic Returns on Effective Rates under the 1982 Tax Law

	Effective tax rate	
Capital risk, α_δ	*General industrial equipment (percent)*	*Industrial structures (percent)*
0.00	−21.8	45.6
0.02	−25.6	53.2
0.04	−29.7	59.0
0.06	−34.1	63.5

Source: Equation 7, with $y = 0.02$, $\pi = 0.06$, and δ taken from table 3. Comparable values to table 4, with $y = 0.04$ and $\alpha_\delta = 0$, are −0.3 percent and 39.7 percent, respectively.

Although there is much evidence on the risk-free rate of return, little is known about the stochastic processes generating the returns from individual assets. Bulow and Summers pointed out that the annual volatility of the stock market was many times as great as that in gross corporate earnings, suggesting that the riskiness of asset values is the dominant problem investors face.[31] However, such asset risk reflects variations in the discount rate applied to earnings as well as variations in the earnings themselves. Furthermore, such variations do not imply that the specific assets owned by firms are as risky. For example, an airline that owns its fleet of planes may have a very volatile share price without the depreciated value of the planes themselves varying very much. Hence it is difficult to infer from such market observations the quantitative importance of variations in depreciation of underlying assets. More empirical work is needed on this issue for conclusions to be drawn.

Nonetheless, it is useful to observe how the introduction of economic depreciation risk alters conclusions about effective tax rates; this is done for a range of reasonable parameter values in table 10. The table shows the values of τ under the 1982 law for an inflation rate of $\pi = 0.06$, an assumed after-tax, risk-free return of $y = 0.02$, and a range of values of α_δ from zero to 0.06. The effective tax rate is calculated for two representative assets, where $\bar{\delta}$ is set equal to the previously used values of δ in table 3. To make comparisons I set the after-tax return lower to account for the fact that this is now meant to be a risk-free rate, and assume that nominal depreciation allowances themselves do not vary, so that z is calculated using $y + \pi$ as the discount rate. The range of values for α_δ is meant to provide bounds for movements in τ. An asset for which $\alpha_\delta = 0.06$ has depreciation so risky that an additional *after-tax* return of 6 percent is required over the risk-free rate (in addition to the risk premium associated with the variability of gross flows).

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[31] Jeremy Bulow and Lawrence Summers, "The Taxation of Risky Assets," Working Paper 897 (National Bureau of Economic Research, June 1982).

Looking at table 10, one can see that the use of a lower after-tax return in itself has an ambiguous effect on the estimated effective tax rate, raising the effective tax rate for structures and lowering the rate for equipment. As α_δ rises, the effective tax rates diverge for the two classes of assets, with the rate rising for structures and falling for equipment. In general it can be shown that effective tax rates will increase with α_δ unless they are negative, in which case they will become even more negative. This is a general result that applies for any increase in the effective depreciation rate, $\bar{\delta} + \alpha_\delta$. Intuitively, one knows that once tax benefits are sufficiently large to provide the investor with a subsidy, this subsidy increases in size relative to the asset's present value of earnings as the lifetime of the asset declines. An increase in capital risk has the effect of shortening an asset's life because it leads the investor to discount future flows more heavily. Thus the expectation that effective tax rates increase with capital risk is valid only if one rules out negative tax rates (which would require a nominal discount rate, $y + \pi$, of at least 11 percent for equipment).

Interest Deductibility and Personal Taxation

Both interest deductibility and personal taxes have been generally ignored until now in this discussion, and the focus has been on tax issues related to the real rather than the financial side of corporate investment. For many questions, however, these features of the tax on capital income are crucial. One of the reasons why the corporation tax receipts have declined over time has been the increase in nominal interest rates. These rising rates, combined with the deductibility of interest payments and the relative stability of the aggregate corporate debt-equity ratio, led to an increase in interest deductions. Even if this is compensated by an increase in individual tax payments, there are implications for the probability that individual corporations will fail to have taxable income and for the viability of the corporate tax as an independent vehicle for raising revenues.

Although the corporate tax is obviously relevant to the choice between corporate and noncorporate investment, the identity of the entity remitting the actual tax payment is of little consequence to the overall incentive to invest in capital. It is important therefore to understand the total tax wedge between the return to corporations before tax and the return to holders of debt and equity after tax, taking account of personal as well as corporate taxes.

Discussions in this area require an understanding of how taxes influence the corporate decision between debt and equity finance. The stability of the aggregate debt-equity ratio at about 1:3 requires some explanation, given the apparent tax advantage to debt finance.[32] Since payments to stockholders in the form of dividends are not tax deductible but interest payments are, there appears to be a strong incentive to finance with debt. Reasons often given for the relatively limited use of debt involve both tax and nontax factors.[33]

Bankruptcy costs are often cited as a reason why corporations do not borrow more. A related argument is that leverage allows a firm to lower the value of its existing long-term debt through investment decisions that make the firm riskier than had been anticipated. This possibility of "cheating" on debt-holders limits the feasible extent of debt finance.

On the tax side, there is a personal tax advantage to equity and a potential corporate tax disadvantage to debt that act to offset debt's apparent tax advantage at the corporate level. For any taxable investor, long-term capital gains receive favorable tax treatment through a 60 percent exclusion and deferral of payment of the tax until the gains are actually realized. The capital gains tax may be the only relevant tax on equity income when marginal equity funds come through retentions. Then the customary approach of weighting dividends and capital gains taxes to derive some overall personal tax rate on equity income has no justification.[34]

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[32] See Gordon and Malkiel, "Corporation Finance," and Robert Taggart, "Secular Patterns in the Financing of U.S.," in Benjamin Friedman, ed., *Corporate Capital Structure in the United States* (National Bureau of Economic Research, forthcoming).

[33] For a review of these theories see Roger H. Gordon, "Interest Rates, Inflation, and Corporate Financial Policy," *BPEA, 2:1982*, pp. 461–88.

[34] This point is developed in the literature. See Mervyn A. King, "Taxation and the Cost of Capital," *Review of Economic Studies*, vol. 41 (January 1974), pp. 21–35; Alan J.

When investment is financed through retention of earnings and hence forgone dividends, stockholders postpone paying taxes on dividends and the earnings they represent. When the retentions and the additional earnings they generate are ultimately distributed, the dividends are taxed. In this respect, the dividend tax is like a consumption tax, allowing deductions for saving by the corporation and taxing withdrawals. The after-tax rate of return is unaffected by the level of tax on dividends. Hence the net effect of such taxation is zero on new investment financed by retentions. (There would, of course, be effects induced by changes in the dividend tax rate.) The positive present value of dividend tax receipts results because the capital currently inside the corporation will be taxed upon distribution and because some equity funds will come from the sale of new shares, for which there is no corresponding personal tax saving.

Even with the relatively small capital gains tax serving as the only effective individual tax on equity income, it remains difficult to argue that very many investors would have a tax preference for equity financing, given that the maximum personal tax rate on interest income is 50 percent, only 4 points higher than the statutory corporate rate at which interest payments are deducted. Moreover, evidence from bond markets suggests that individuals in tax brackets substantially below the top marginal rate can limit their tax liability by holding tax-exempt municipal debt.[35] Hence the potential individual tax gain from holding equity versus debt would appear to be substantially below the corporate tax rate.

Even if increased leverage does not lead to a serious threat of bankruptcy, however, it increases the probability that the full value of interest deductions themselves will not be received. Hence borrowing to take advantage of tax deductibility will tend to be self-limiting. A recent study using actual corporate tax returns for 1978 estimated that under the 1983 tax law the average marginal tax rate at which interest

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Auerbach, "Share Valuation and Corporate Equity Policy," *Journal of Public Economics*, vol. 11 (June 1979), pp. 291–305; and David F. Bradford, "The Incidence and Allocation Effects of a Tax on Corporate Distributions," *Journal of Public Economics*, vol. 15 (April 1981), pp. 1–22. For a detailed discussion of its implications, see Alan J. Auerbach, "Taxation, Corporate Financial Policy and the Cost of Capital," *Journal of Economic Literature*, vol. 21 (September 1983), pp. 905–40.

[35] Joseph J. Cordes and Steven M. Sheffrin, "Estimating the Tax Advantage of Corporate Debt," *Journal of Finance*, vol. 38 (March 1983), pp. 95–105.

payments would be deductible is 0.31 percent, not allowing for the possibility of carrying back these deductions or the expected value from carrying them forward.[36] However, this may overstate the calculations based on the transition probabilities in table 7. They suggest that, with a nominal discount rate of 10 percent, a typical firm will receive about 92 cents per dollar of interest deductions, in present value, equivalent to immediate deduction at a rate of over 42 percent. Thus, assuming an individual tax rate on debt of below 30 percent, there remains an advantage to debt that can only be explained by nontax factors such as those mentioned above.

An implication of this result is that firms or individual assets for which nontax borrowing costs are small are likely to face a relatively low overall effective tax rate. It has often been supposed that this is the case for structures, as compared to equipment.[37] This would be an important offset to the apparent bias against structures imposed by the corporate tax. However, while highly leveraged purchases of apartment buildings and shopping centers by doctors and other professionals may be common, there has yet to be any convincing empirical evidence suggesting this is an important effect for corporate level investment.[38] Thus there is no evidence that the results derived above concerning differential taxation of assets would be qualitatively affected by the incorporation of interest deductibility and personal taxes in the calculations.

Inflation and the Effective Tax Rate

The primary reason why effective corporate tax rates did not fall appreciably during the 1970s was that inflation increased steadily over the period. This decreased the real value of depreciation allowances received and led to the taxation of nominal inventory profits. For capital purchased by corporations, however, the overall incentive to invest is affected by inflation in three additional ways: through the increase in inflation premiums on debt that are tax deductible, through the increased individual taxation of such premiums, and through the taxation of capital gains of shareholders that are purely nominal in character. The aggregate impact of inflation on the effective tax on capital has been the subject of several studies. Two of the major studies reached quite different conclusions about the sensitivity to inflation of the tax wedge on corporate source income.

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[36] Gordon and Malkiel, "Corporation Finance," estimate that, before the tax reduction of 1981, the marginal tax rate implicit in municipal debt was between 20 percent and 30 percent.

[37] This viewpoint is stated, for example, in Robert E. Hall, "Tax Treatment of Depreciation, Capital Gains, and Interest in an Inflationary Economy," in Hulten, ed., *Depreciation, Inflation, and the Taxation of Income from Capital*, pp. 149–66.

[38] I found no evidence using firm panel data (which included information on asset composition) that structures were financed more heavily with debt than equipment. I did find, however, that the presence of a tax loss carry-forward exerted a negative impact on leverage, as would be expected. See Alan J. Auerbach, "Real Determinants of Corporate Leverage," in B. Friedman, ed., *Corporate Capital Structure in the United States* (National Bureau of Economic Research, forthcoming).

Feldstein and Summers estimated the total tax wedge by combining a weighted average of estimated marginal tax rates of holders of corporate securities with average tax rates at the corporate level, and found the total tax rate to be very sensitive to inflation.[39] For example, they estimated that in 1970 there was a total effective tax rate on corporate source income of 76.8 percent at an inflation rate of 5.5 percent, with 26.6 percent of the taxes collected due to inflation. This translates into an increase of 3.3 percentage points in the total effective tax rate per percentage point increase in the inflation rate.

Using a cost-of-capital methodology such as the one used in this paper to account for both corporate and individual taxes, King and Fullerton found both a lower tax wedge and a much smaller sensitivity to the inflation rate.[40] Under the same 1970 tax law, they estimated that a rise in the inflation rate from zero to 6⅞ percent would have raised the estimated effective tax rate by 3.5 percentage points, from 43.7 to 47.2 percent, or 0.5 percentage point per percentage point increase in the inflation rate.

The major reason for the difference in the conclusions of these two studies appears to be differing assumptions about the marginal tax rate for individuals and the marginal tax rate faced by financial intermediaries. Estimates of the impact of inflation are particularly sensitive to assumptions about the marginal tax rate faced by recipients of corporate interest payments. An expression analogous to equation 4 can be derived for the total effective tax rate, τ_T, accounting for interest deductibility and all

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[39] Feldstein and Summers, "Inflation and the Taxation of Capital Income in the Corporate Sector."

[40] King and Fullerton, eds., *The Taxation of Income from Capital.*

Table 11. The Sensitivity of Effective Overall Tax Rates to Interest Deductibility and Inflation[a]
Percent

Inflation rate	*General industrial equipment*				*Industrial structures*			
	Base	*Low*	*Inter-mediate*	*High*	*Base*	*Low*	*Inter-mediate*	*High*
No inflation	−47.6	−70.9	−54.0	−45.5	25.3	13.5	22.1	26.4
4 percent	−11.4	−46.5	−21.1	−7.5	36.3	16.2	30.7	38.5
8 percent	8.2	−35.3	−3.8	13.2	42.3	15.0	34.7	45.5

Source: Author's calculations as described in the text.
a. Low estimates assume $b = 0.5$ and $\theta = 0.2$; intermediate estimates, $b = 0.25$ and $\theta = 0.2$; high estimates, $b = 0.25$ and $\theta = 0.4$.

taxes paid by the holders of corporate securities. The expression is the same as equation 4 except that r in the second term is replaced by the net return to investors after all taxes, n, and this accounts for the fact that r itself depends on personal income tax rates and corporate interest deductibility.

$$\tau_T = \frac{(r + \delta)(1 - k - uz) - (n + \delta)(1 - u)}{(r + \delta)(1 - k - uz) - \delta(1 - u)}. \tag{8}$$

If investors receive a real net return of n on both equity and debt and marginal equity finance is through retentions, it is easy to show that[41]

$$r = n\left[b\frac{1 - u}{1 - \theta} + (1 - b)\frac{1}{1 - \gamma}\right] + \pi\left[b\frac{\theta - u}{1 - \theta} + (1 - b)\frac{\gamma}{1 - \gamma}\right], \tag{9}$$

where γ is the accrual equivalent tax on capital gains and θ is the personal tax on interest income.

In addition to the effect on r, inflation also affects the present value of the depreciation allowances, z. Using 8 and 9, one can estimate the marginal impact of inflation on τ_T for different assets and tax parameters. This is done in table 11 for the two representative assets, industrial equipment and structures, under the current tax system. In all calculations I set $r = 0.04$, $\gamma = 0.05$, and $u = 0.46$, and estimated effective tax rates at different inflation rates under different assumptions about the parameters θ and b. For the sake of comparison, calculations based on the earlier assumptions that $\theta = b = \gamma =$ zero are presented in the

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[41] See Auerbach, "Inflation and the Tax Treatment of Firm Behavior."

"base" column. Since *r* is taken as given in the calculations, the net return to investors, *n*, varies with the rate of inflation.

As can be seen in table 11, the introduction of interest deductibility and personal taxes has the effect of lowering the overall effective tax rate on both equipment and structures for the low and intermediate cases. These are the cases in which the net impact of the additional tax features makes the net return *n* exceed *r*. It is in these same cases that an increase in inflation raises *n*, given *r*, as the initial effect is simply magnified by the increases in the nominal interest rate. This reduces the sensitivity of the overall tax rate to inflation. For the intermediate case in which the debt-assets ratio is set at 0.25 and the personal tax rate at 0.2, the effective tax rate on equipment rises from −54.0 percent to −3.8 percent, while that on structures rises from 22.1 percent to 34.7 percent as inflation increases from zero to 8 percent. The general result that the tax rates faced by short-lived assets are more sensitive to inflation has been documented previously.[42] Raising the assumed personal tax rate on interest income from 0.2 to 0.4, in line with Feldstein and Summers, makes both tax rates rise more rapidly. On the other hand, setting $b = 0.5$ instead of 0.25 essentially removes the effect of inflation on the tax rate for structures. Since it has been argued that observed debt-asset ratios may understate *marginal* leverage, this may be a reasonable assumption to make.[43] Hence it appears difficult to measure with great confidence the impact that inflation has on the effective tax rates facing fixed investment.

Asset Valuation and Deferred Taxes

Just as aggregate revenues from the corporate tax are often cited as evidence of the tax's overall impact, it is customary to measure the magnitude of tax incentives for investment by the associated loss in annual tax receipts. The error involved in doing so can be quite severe.

For example, suppose there was a change in the timing of depreciation allowances that accelerated their rate of receipt but compensated for this with a lower base on which the allowances were calculated so that the net impact on the present value of these depreciation allowances is nil. There would be no impact on the incentive to invest, nor would there be any obvious reason why the shortfall in government revenue caused by the earlier deduction of depreciation allowances would have an effect on saving: owners of assets receiving these "tax cuts" would have to repay them in the future, with interest. By assumption, the government has not given them a *net* increase in resources.

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[42] See Alan J. Auerbach, "Inflation and the Choice of Asset Life," *Journal of Political Economy*, vol. 87 (June 1979), pp. 621–38.

[43] See Joseph E. Stiglitz, "Taxation, Corporate Financial Policy and the Cost of Capital," *Journal of Public Economics*, vol. 2 (February 1973), pp. 1–34.

This argument might seem to carry over directly to the case of all taxes: if the government, in the long run, repays its debt, lower taxes today must be compensated for by higher ones in the future. A significant difference between taxes in general and taxes on capital assets is that future taxes on capital assets are immediately capitalized. One does not have to believe in Barro's altruistic families to conclude that a pure change in the timing of such tax payments will be neutral.[44] It is not even necessary that the owners of such assets look beyond the present. This neutrality is the result of simple arbitrage. Assets that already have received a tax benefit but now are liable for future "deferred taxes" are less attractive to the owner than comparable new assets that have yet to receive the initial benefits.

Consider, for example, a five-year-old piece of equipment under current law that has no remaining depreciation deductions or investment tax credits. For it, the value of $k + uz$, in the terminology used above, is zero. The cash flows that it generates in the future will be fully taxable. A comparable new asset is more attractive (*after* adjustment for differences in real productivity), because for it the value of $k + uz$ is not zero. Hence its value will be higher, by the ratio $1/(1 - k - uz)$.

A related reason why old assets should carry a discount is the general practice of introducing investment incentives that apply only to new assets. The motivation for this practice is that increases in investment tax credit or acceleration of depreciation allowances provides more "bang for the buck" in terms of reductions in the cost of capital per dollar of revenue lost. This is not surprising, given that such incentives do not lower the effective tax rate on existing capital goods, while broader changes such as corporate rate reductions do. The gap between the taxation of old and new assets caused by such investment incentives leads to a further discount in the value of old assets relative to new ones.[45] A corollary is that when there is inflation, old assets will be discounted because their depreciation allowances are based on a lower price index than those of new assets.[46]

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[44] Robert J. Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, vol. 82 (November–December 1974), pp. 1095–1117.

When older assets face higher effective tax rates than new ones, the resulting discount in their value may be considered to be caused by an implicit obligation to the government to pay taxes in excess of those due on comparable new assets. The difference in market value of the old and new assets should reflect the present value of the obligation. In particular, the owner of such an asset could offset this difference in future obligations by committing the difference in the value of the two assets to government debt and using the interest payments to cover the extra taxes due in the future. Hence the current tax system is equivalent to a tax that imposes the same effective rate on old and new assets, combined with a liability of owners of old assets to the government equal to the total tax-induced discount on old assets under the current system.

Recognizing this point is important because tax revenues in a given year can change for many reasons: a change in the corporate tax burden in general, a change in the relative tax burdens on old and new assets, or a change in the timing of the collections. These have very different substitution effects through the cost of capital and very different income effects through changes in the value of existing assets. It is impossible to draw any general conclusion from a drop in current corporate revenues about whether the incentive for corporations to invest has increased or whether potential crowding out has been increased through a rise in private wealth.

For example, an upward movement in the statutory corporate tax rate, combined with a further acceleration of depreciation allowances aimed at maintaining the same incentive to invest in new capital, would increase the present value of corporate tax receipts by what is essentially a lump-sum tax on existing capital. This may be thought of as forcing the owners of such capital to assume an additional debt to the government. The real effects of such a policy would be equivalent to that of a one-time lump-sum tax used to retire government debt, a scheme without direct substitution effects. Yet, as measured, this policy would quite possibly appear to increase the current deficit, due to the acceleration of depreciation allowances on new capital.[47] It would clearly be desirable to have annual corporate revenues after adjustment include changes in the value of the deferred tax liability of asset holders to the government. Assuming that markets capitalize future taxes, such an adjustment is equivalent to an estimate of the size of the discount on existing capital due to the tax system.

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[45] This presumes that old assets are not sold to take advantage of the new provisions. Even ignoring transaction costs, such behavior would only yield a net reduction in taxes for a small fraction of the capital stock, because of the tax treatment of the sale and the limited availability of the investment tax credit for used assets. See Auerbach, "Inflation and the Tax Treatment of Firm Behavior," and Alan J. Auerbach and Laurence Kotlikoff, "Investment versus Savings Incentives: The Size of the Bang for the Buck and the Potential for Self-Financing Business Tax Cuts," in L. H. Meyer, ed., *The Economic Consequences of Government Deficits* (Kluwer-Nijhoff, 1983), pp. 121–49.

[46] See Auerbach, "Inflation and the Choice of Asset Life."

To estimate the relation between the value of an existing unit of capital and its replacement cost, note that at any time the value of the after-tax flows from a new unit of capital equals its purchase price. Normalizing this price to 1 yields

$$1 = (1 - u)F + k + uz, \tag{10}$$

where F is the present value of the asset's before-tax flows, and u, k, and z are as defined in equation 1. For an existing capital good of age t, which under the assumption of geometric decay is equivalent in terms of productivity to $(1 - \delta)^t$ units of new capital, the value is

$$v^t = (1 - u)F(1 - \delta)^t + uz^t, \tag{11}$$

where z^t is the present value of depreciation allowances that remain for the asset. The ratio of market value to replacement cost of such an asset, its q value, is

$$q^t = \frac{v^t}{(1 - \delta)^t} = (1 - k - uz) + \frac{uz^t}{(1 - \delta)^t}. \tag{12}$$

This differs from Tobin's q by the assumption that, except for tax effects, old capital is valued at its replacement cost. This value equals 1 when $z^t = (1-\delta)^t (k+uz)$: assets receive tax benefits proportional to their productivity or physical value. This would be true under a tax on economic income, for then $k + uz$ would equal $\delta/(r+\delta)$ and z^t would equal $[\delta/(r+\delta)](1-\delta)^t$. Generally, however, q^t is below 1. Even without the intentional acceleration of depreciation allowances, inflation causes the present value of old allowances based on original asset purchase prices to fall well short of the value of allowances new assets receive.

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[47] An example of this problem of confusing changes in timing and changes in the tax burden came in the discussion of my proposal with Dale Jorgenson to give investors the discounted value of economic depreciation allowances in the year of an asset's purchase. See Alan J. Auerbach and Dale W. Jorgenson, "Inflation-Proof Depreciation of Assets," *Harvard Business Review*, vol. 58 (September–October 1980), pp. 113–18. Although our original proposal would not have lowered effective tax rates on capital in the aggregate, some viewed it as infeasible because of the large "deficits" it would have produced in the initial years of its application.

Using equation 12, I estimated the values for q^t for all vintages of each of the thirty-four asset classes from 1953 to 1982, ignoring tax law changes before 1953. These vintage-specific values of q were aggregated into the annual asset-specific average of q under the assumption that each net asset stock grew over the period at a growth rate of 4 percent.[48] With the use of capital stock weights described in appendix A, these were aggregated to form a single series for the overall value of average q, shown in the first column of table 12. The series is characterized by a downward trend. In the 1950s the average q values actually exceeded unity for some assets. With the investment tax credit, accelerated depreciation, and inflation, these values fell. Large reductions occurred with the tax changes of 1962, 1972, and 1981. The corporate rate reductions in the mid-1960s and late 1970s had no observable impact, since they applied uniformly to old and new capital. Note also that q increased in years when the treatment of new capital goods was made less favorable, as occurred with the removal of the investment tax credit in 1967 and again in 1970.

As suggested above, this divergence of average q from 1 is essentially a deferred tax liability of holders of existing assets. The second column of table 12 shows the adjustments to annual revenue that would be made if such debt were explicitly accounted for. The numbers equal each year's change in the value of the implicit debt,[49] less real after-tax interest payments on the stock of such debt, based on a return of 2 percent. By

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[48] This is the annual growth rate of the net corporate stock of fixed nonresidential capital from 1952 to 1981, based on numbers presented in John C. Musgrave, "Fixed Capital Stock in the United States: Revised Estimates," *Survey of Current Business*, vol. 61 (February 1981), pp. 57–68; and Musgrave, "Fixed Reproducible Tangible Wealth in the United States."

[49] The value of the implicit debt for each year equals $(1 - q)$ multiplied by the aggregate net stock of fixed corporate capital, taken from Musgrave, "Fixed Capital Stock in the United States: Revised Estimates" and "Fixed Reproducible Tangible Wealth in the United States."

Table 12. Average Values of *q* Implied by the Corporate Tax Law, 1953–82

Year	*Average q (ratio)*	*Implied revenue adjustment (billions of 1972 dollars)*
1953	0.921	. . .
1954	0.898	7.6
1955	0.908	−2.6
1956	0.924	−4.7
1957	0.935	−3.4
1958	0.940	−1.9
1959	0.940	0.1
1960	0.946	−2.1
1961	0.945	0.5
1962	0.894	21.0
1963	0.900	−2.0
1964	0.893	4.0
1965	0.898	−0.4
1966	0.899	1.9
1967	0.927	−12.9
1968	0.889	22.6
1969	0.890	1.8
1970	0.928	−21.8
1971	0.926	1.9
1972	0.867	40.1
1973	0.864	5.1
1974	0.865	1.9
1975	0.867	−1.2
1976	0.845	17.3
1977	0.834	10.2
1978	0.835	1.6
1979	0.838	0.7
1980	0.838	2.6
1981	0.781	60.8
1982	0.792	n.a.

Source: Author's calculations as described in the text.
n.a. Not available.

this measure, corporate tax revenues were really 134.6 billion (current) dollars higher than the amount reported in 1981 because of the substantial increase in the implicit debt held by owners of existing capital.

The Future of the Corporate Tax

As a fraction of GNP, the corporate tax now raises less than a third of what it did three decades ago. While effective marginal tax rates on investment have declined accordingly, the distortions of the corporate tax structure have not. The calculations in table 6 suggest a steadily worsening allocation of fixed capital within the U.S. corporate sector.

Many other problems remain, too. The use of accelerated depreciation and the investment tax credit to reduce effective tax rates have made the problem of tax losses more acute. Any resemblance between economic income and taxable income that existed thirty years ago has vanished, and many profitable companies, particularly those that are growing, cannot use all their tax benefits. Though effective tax rates are lower than they were in the 1970s, they still are sensitive to the inflation rate because of the use of nominal magnitudes in calculating the tax base. Finally, the choice between debt and equity finance remains distorted by the presence of two levels of taxation of corporate source income.

Given the low level of corporate revenues at present, abolition of the corporate tax has its appeal. Such a move would certainly alleviate some of the problems described above. At the same time, however, it would be a singularly ineffective way of stimulating investment because it would reduce average tax rates much more than marginal tax rates.

As shown in table 4, the effective corporate tax rate on new, equity-financed fixed capital is now below 25 percent. Removal of the corporate tax would bring this rate to zero but would also eliminate the substantial benefit of interest deductibility. Thus it would probably result in a very small net reduction in taxation for new investments. At the same time, repeal of the corporate tax would forgive the implicit debt owed the government in deferred taxes, currently in excess of 20 percent of the fixed corporate capital stock. Given the capital stock's 1981 replacement cost of $2.05 trillion, this amounts to a transfer of $427 billion.[50]

The continued interest in the consumption tax as an alternative to the individual income tax and, indeed, the recent moves toward such a tax through the sheltering of individual capital income also provide an argument for removing the corporate tax, for capital income would not be taxed under a consumption tax. An alternative scheme that would have the same marginal impact without the windfalls is a cash-flow tax, discussed in detail by the Meade Committee in the United Kingdom as a companion for a personal consumption tax.[51] Like a consumption tax, it would amount to a tax on the difference between initial assets plus income and final assets in each tax period, in this case at the corporate level. The most straightforward method of accomplishing this would be through the immediate expensing of gross investment (real plus financial) in conjunction with the continued taxation of gross income, before depreciation. The chief drawback of the cash-flow tax, however, is that it does not solve the problem of tax losses in the way that repeal of the corporate tax would. Otherwise, the two alternatives differ primarily in the size of the wealth transfer to owners of corporations.

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[50] See Musgrave, "Fixed Reproducible Tangible Wealth in the United States."

[51] Institute for Fiscal Studies, *The Structure and Reform of Direct Taxation* (London: Allen and Unwin, 1978).

If the corporate tax is not to be repealed outright, the problem of tax losses must be addressed. Straightforward economic solutions exist: unlimited carrying forward with interest, for example, would maintain protection against fraudulent loss claims while at the same time preserving the value of tax deductions for viable enterprises. But one should take warning from the recent legislative fiasco involving safe-harbor leasing. This is an area of tax policy in which common perceptions seem particularly resistant to economic evidence.

APPENDIX A

Methodology and 1954–82 Changes in Tax Code

THIS APPENDIX presents the methodology used to calculate effective tax rates in the text.

The first step in these calculations is to estimate each asset's effective tax rate according to equation 4. As already stated, it is assumed that investors all used accelerated methods where available. Investments are assumed to take place midway through the year, with the investment credit and (before 1981) half the first full year's depreciation allowances received immediately. Marginal products and remaining depreciation allowances are assumed to come at subsequent one-year intervals.

The major changes in the tax code taken into account are as follows.

1954 Introduction of accelerated methods; all assets are assumed to use double-declining balance with a switch-over to straight-

	line methodology, instead of the straight-line previously assumed.
1962	Introduction of a 7 percent investment tax credit (with full-basis adjustment) and of shortened "guideline" lifetimes by the U.S. Department of the Treasury, instead of Bulletin F lifetimes previously assumed.
1964	Repeal of basis adjustment for investment tax credit. A cut in corporate tax rate from 52 percent to 50 percent.
1965	A cut in corporate tax rate from 50 percent to 48 percent.
1967	Suspension of investment tax credit.
1968	Introduction of 10 percent surcharge on income tax.
1969	Reinstatement of investment tax credit.
1970	Removal of investment tax credit, reduction of surcharge, reduction of structures write-off to 150 percent declining balance, with switch-over to straight-line methodology.
1971	Removal of surcharge.
1972	Shortening of asset lives through the asset depreciation range system; reintroduction of investment tax credit.
1975	Increase of investment tax credit to 10 percent.
1979	Reduction in corporate tax rate from 48 percent to 46 percent.
1981	Economic Recovery Tax Act, as described in the text.
1982	Tax Equity and Fiscal Responsibility Act, as described in text.

The years listed are the first for which the changes are included. Except for the 1982 act, any change was counted in the year enacted if it was effective before July 1 of that year. Otherwise, it was deferred to the following year. The 1982 act became effective after July 1, but is included for 1982 to allow an analysis of its effects.

Special tax rules apply to public utility structures and oil-drilling equipment. The latter category is problematic because there are various depletion and write-off provisions that are difficult to capture in the current framework. The calculations here follow the assumptions used in King and Fullerton.[52]

To convert these asset-specific rates into industry rates, the capital stock matrix also used by King and Fullerton was adopted. This 44 × 34 matrix has entries equal to the estimates for 1977 of the net stock of each type of the thirty-four assets present in each of the forty-four industries. This matrix is converted to a corporate version using estimates for each industry of the fractions of equipment and structures in the industry that are held by corporations. The capital stocks themselves were derived by Fraumeni and Jorgenson, using data on capital flows and annual levels of industry-by-industry investment.[53] Further details are provided by King and Fullerton.

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[52] King and Fullerton, eds., *The Taxation of Income from Capital.*

APPENDIX B

Measuring the Deadweight Loss from Differential Corporate Taxation

ASSUMING that value added in industry i can be represented by the Cobb-Douglas production function, one obtains

$$(13)\qquad Y_i = a_i \underset{j}{\pi} K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} \qquad \beta_i = \sum_j \alpha_{ji},$$

where K_{ji} is the capital stock of category j used in industry i and X_i is labor used in industry i. With no loss of generality, one can define capital stock units so that the relative price of each capital good, q_j, equals 1.

Consider first the case in which capital is allocated according to the actual costs of capital imposed by the market. By the normalization that $q_j = 1$, the cost of capital type i is

$$(14)\qquad c_j = \frac{r}{1 - \tau_j} + \delta_j = \rho_j + \delta_j,$$

where τ_j is the effective tax rate, r is the real after-tax return (assumed to be 4 percent), and δ_j is the asset's depreciation rate. One may think of corporate sector allocation as being made by a single, competitive firm seeking to maximize profits, where profit equals gross output (including depreciation) less the cost of capital, subject to the constraint that the vector of actual outputs, $\overline{Y} = (\overline{Y}_1, \ldots)$, be produced and the economy's actual stock of labor, $\overline{X}$, be used. This yields a Lagrangian expression for the actual capital stock, K^a,

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[53] See Barbara M. Fraumeni and Dale W. Jorgenson, "Capital Formation and U.S. Productivity Growth, 1948–1976," in Ali Dogramaci, ed., *Productivity Analysis: A Range of Perspectives* (Martinus Nijhoff Publishing, 1981), pp. 49–70.

$$K^a = \max \sum_i \left(a_i \underset{j}{\pi} K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} + \sum_j \delta_j K_{ji} - \sum_j c_j K_{ji} \right) \tag{15}$$

$$- \sum_i \theta_i \left(a_i \underset{j}{\pi} K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} - \overline{Y}_i \right) + \phi \left(\sum_i X_i - \overline{X} \right).$$

The first-order conditions from 15 may be combined to yield

$$K^a = \sum_i \left(\frac{\phi^{(1-\beta_i)} \tilde{\rho}_i^{\beta_i} \overline{Y}_i}{\nu_i} \cdot \sum_j \frac{\alpha_j}{r_j} \right), \tag{16}$$

where

$$\sum_i \left(\frac{\phi^{-\beta_i} (1 - \beta_i) \tilde{\rho}^{\beta_i} \overline{Y}_i}{\nu_i} \right) = X, \tag{17}$$

$$\nu_i = a_i \underset{j}{\pi} \alpha_{ji}^{\alpha_{ji}} (1 - \beta_i)^{(1-\beta_i)}, \tag{18}$$

and

$$\tilde{\rho}_i = \underset{j}{\pi} \rho_j^{\alpha_{ji}/\beta_i} \tag{19}$$

is the weighted geometric mean of the required, before-tax rates of return in industry *i*.

Equations 16 and 17 can be simplified. Note that, under competitive conditions, the total supply of labor, $\overline{X}$, satisfies

$$\overline{X} = \frac{1}{w} \sum_i (1 - \beta_i) \overline{Y}_i \tag{20}$$

(where w is the competitive wage), and the technological term, ν_i, also equals

$$\nu_i = \tilde{\rho}_i^{\beta_i} w^{1-\beta_i}. \tag{21}$$

One may choose the units of labor so that $w = 1$, with no loss of generality, and use equations 20 and 21 to reexpress 16 and 17:

$$K^a = \sum_i \phi^{(1-\beta_i)} \overline{Y}_i \cdot \sum_j \alpha_j / \rho_j, \tag{22}$$

where

$$\sum_i (\phi^{-\beta_i} - 1)(1 - \beta_i)\overline{Y}_i = 0. \tag{23}$$

The solution to 23 is $\phi = 1$. This is not surprising because ϕ is the shadow price of labor (see 15), that is, the market wage.

The minimum capital stock necessary to produce $\overline{Y}$, holding $\overline{X}$ fixed, is found by solving the Lagrangian,

$$K^* = \min \sum_i \sum_j K_{ji} - \sum_i \lambda_i (a_i \prod_i K_{ji}^{\alpha_{ji}} X_i^{1-\beta_i} - \overline{Y}_i) + \gamma\left(\sum_i X_i - \overline{X}\right). \tag{24}$$

Using the same solution technique as before, one obtains

$$K^* = \sum_i \left(\frac{\gamma^{(1-\beta_i)} \beta_i Y_i}{\nu_i}\right), \tag{25}$$

where

$$\sum_i \left(\frac{\gamma^{-\beta_i}(1 - \beta_i)\overline{Y}_i}{\nu_i}\right) = \overline{X}. \tag{26}$$

Again using 20 and 21, 25 and 26 can be rewritten as

$$K^* = \sum_i \gamma^{(1-\beta_i)} \bar{\rho}_i^{-\beta_i} \beta_i \overline{Y}_i, \tag{27}$$

where

$$\sum_i [(\gamma\bar{\rho}_i)^{-\beta_i} - 1](1 - \beta_i)\overline{Y}_i = 0. \tag{28}$$

The term γ may be thought of as the inverse of the weighted-average aggregate cost of capital. If $\bar{\rho}_i$ were constant across i, it would equal $1/\gamma$. For purposes of exposition, we define $\bar{\rho} = 1/\gamma$. Subtracting the expression for K^* from that for K^a yields an expression for the "wasted" capital stock,

$$\Delta K = \sum_i Q_i \sum_j \left(\frac{\alpha_{ji}}{\beta_i}\right)\left(\frac{\bar{\rho}_i}{\rho_j} - 1\right) + \sum Q_i\left[1 - \left(\frac{\bar{\rho}_i}{\bar{\rho}}\right)^{(1-\beta_i)}\right], \tag{29}$$

where

$$Q_i = \overline{Y}_i \beta_i \bar{\rho}_i^{-1}. \tag{30}$$

It may be shown that the first sum on the right-hand side of 29 achieves a minimum of zero when $\bar{\rho}_i = \rho_j \; \forall_{i,j}$, and that the second term achieves a minimum of zero when $\bar{\rho}_i$ is constant over i and (by 28) equal to $\bar{\rho}$. Hence it is natural to interpret these terms as the wastage due to variation in effective tax rates within industries, and between them, respectively. Dividing equation 29 by equation 22 gives an estimate of the *fraction* of the capital stock that is wasted,

$$(31)\qquad L = \frac{\Delta K}{K} = \frac{\sum_i Q_i \sum_j \left(\frac{\alpha_{ji}}{\beta_i}\right)\left(\frac{\bar{\rho}_i}{\rho_j} - 1\right) + \sum_i Q_i\left[1 - \left(\frac{\bar{\rho}_i}{\bar{\rho}}\right)^{(1-\beta_i)}\right]}{\sum_i Q_i \sum_j \left(\frac{\alpha_{ji}}{\beta_i}\right)\left(\frac{\bar{\rho}_i}{\rho_j}\right)}.$$

To solve 31, I set β_i equal to the share of capital in value added in industry i taken from the 1972 Census of Manufactures, $\overline{Y}_i$ equal to that value added, and use the 1977 capital stock weights described in appendix A for (α_{ji}/β_i). Because three of the forty-four industries (numbers 38, 39, and 40) are combined in the Census (which has forty-two industry categories), I combine these three industries' capital stocks in doing the calculations. The terms ρ_j come from each year's estimated effective tax rates by asset category.

APPENDIX C

Estimating the Effective Tax Rate on Risky Assets

THE ANALYSIS in this section uses the methodology presented in Alan J. Auerbach, "Evaluating the Taxation of Risky Assets," Working Paper 806 (National Bureau of Economic Research, November 1981).

Suppose capital of a certain type is homogeneous and depreciates each year at some stochastic rate, δ, yielding a risky cash flow, f, per unit of capital. Assume for simplicity that δ and f are jointly independently and identically distributed over time with means $\bar{\delta}$ and $\bar{f}$, respectively.

Let i be the discount rate that, when applied to the mean $\bar{f}$, yields the risk-adjusted present value of f. Define x similarly for δ, and let y denote the risk-free rate. Note that because depreciation represents a negative contribution to the firm's overall return, the riskiness of δ would normally lead to a risk-adjusted discount rate, x, that is *below* the risk-free rate, y. (Indeed, x may be considerably less than zero.) This corresponds to the normal result of risk reducing the value of the future expected return, in this case by magnifying δ.

A simplification is made for convenience of notation. Observe that any system of depreciation allowances and investment tax credits has the same value to the investor ex ante as a scheme that allows fractional economic depreciation at rate ψ. With this simplification, and because of the stationarity and independence of $\bar{f}$ and $\bar{\delta}$ over time, one may consider the firm as facing a series of identical one-period decisions. The condition for equilibrium is that the risk-adjusted one-period holding yield equals the interest rate, or

$$\text{(32)} \qquad \frac{\bar{f}(1-u)}{1+i} - \frac{\bar{\delta}}{1+x} + \frac{u\psi\bar{\delta}}{1+x} = \frac{y}{1+y},$$

where, as before, u is the statutory tax rate.

To solve for ψ, one must know the present value of economic depreciation. The value of this period's depreciation is $\bar{\delta}/(1 + x)$. The next period's value is the value seen from the next period per dollar of capital, also $\bar{\delta}/(1 + x)$, multiplied by the present value of capital at the beginning of next period, $[1/(1 + r)] - [\bar{\delta}/(1 + x)]$. Continuing in this way, one can obtain the present value of economic depreciation,

$$\text{(33)} \qquad z_E = \frac{\bar{\delta}}{1+x} + \left(\frac{1}{1+y} - \frac{\bar{\delta}}{1+x}\right)\frac{\bar{\delta}}{1+x} + \cdots \left[\left(\frac{1}{1+y} - \frac{\bar{\delta}}{1+x}\right)^{t}\frac{\bar{\delta}}{1+x}\right] + \cdots = \frac{\bar{\delta}}{\bar{\delta} + y\left(\dfrac{1+x}{1+y}\right)}.$$

Thus if actual depreciation allowances provide value z, and there is an investment tax credit at rate k, one obtains

$$\text{(34)} \qquad \psi = \frac{k + uz}{u\bar{\delta}}\left[\bar{\delta} + y\left(\frac{1+x}{1+y}\right)\right],$$

which, when substituted into 32, yields

$$\text{(35)} \qquad \frac{\left[\dfrac{\bar{f}(1-u)}{1-k-uz}\right]}{1+i} - \frac{\bar{\delta}}{1+x} = \frac{y}{1+y}.$$

This can also be written

$$\left(\frac{\bar{f}(1-u)}{1-k-uz}-\bar{\delta}\right)=y+\alpha_f\left(\frac{1-u}{1-k-uz}\right)+\alpha_\delta, \tag{36}$$

where

$$\alpha_f=\bar{f}\left(\frac{i-y}{1+i}\right) \tag{37a}$$

$$\alpha_\delta=\bar{\delta}\left(\frac{y-x}{1+x}\right). \tag{37b}$$

The terms α_f and α_δ are the risk premiums associated with the riskiness of $\bar{f}$ and $\bar{\delta}$, respectively. At one extreme, where only f is risky, the asset's annual returns are independent. At the other extreme, with only δ risky, the asset's annual return follows a random walk with a drift of $-\bar{\delta}$.

Once again one can define the effective tax rate as the particular rate that would provide the same incentive to invest as the current system. Because under an income tax at rate τ the equilibrium condition for holding period yield is

$$\frac{\bar{f}(1-\tau)}{1+i}-\frac{\bar{\delta}(1-\tau)}{1+x}=\frac{y}{1+y}, \tag{38}$$

equations 36 and 37 can be combined to solve for the effective tax rate analogous to equation 4 in the text:

$$\begin{aligned}\tau &= \frac{(\bar{f}-\alpha_f)-(y+\bar{\delta}+\alpha_\delta)}{(\bar{f}-\alpha_\delta)-(\bar{\delta}+\alpha_\delta)} \\ &= \frac{(\bar{y}+\delta+\alpha_\delta)(1-k-uz)-(\bar{y}+\delta+\alpha_\delta)(1-u)}{(y+\bar{\delta}+\alpha_\delta)(1-k-uz)-(\bar{\delta}+\alpha_\delta)(1-u)}.\end{aligned} \tag{39}$$

The effective tax rate is precisely the rate that would apply in the absence of risk for a risk-free rate, y, and an economic depreciation rate, $\bar{\delta}+\alpha_\delta$. Hence two corrections must be made for the effective tax rates calculated above: replace the return, r, with a risk-free return and, as suggested by Bulow and Summers, consider economic depreciation to be at rate $\bar{\delta}+\alpha_\delta$.[54]

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[54] Bulow and Summers, "The Taxation of Risky Assets."

Comments and Discussion

Henry J. Aaron: Alan Auerbach has written an ambitious, original, and provocative paper on an important subject. More accurately, he has written several mini-papers on a variety of subjects and grouped them under a single title. My comments are selective.

My first comment concerns the estimates of the capital wastage from tax-related distortions.

To begin at the beginning, the corporation income tax potentially causes a variety of distortions. First, it creates a tax wedge between corporate and noncorporate activity unless other tax provisions offset it. This is the problem on which Harberger wrote his classic article.[1] This distortion is reflected in a distortion of both the composition of output and the methods of production. Although Harberger did not analyze them, additional distortions would result in the supply of factors of production. Second, the effective tax rate varies among categories of capital goods because taxable depreciation differs from true depreciation by varying amounts across classes of capital goods. The effective tax rate varies across firms both because they employ different mixes of capital goods that are variously taxed and because they have different profit histories and prospects. Although Auerbach late in his paper estimates how variations in profit histories and prospects change effective rates, he does not use these estimates in calculating capital wastage.

These features of the corporation income tax distort factor supplies and cause a misallocation of capital and labor both between the corporate and noncorporate sectors and between various industries and firms within the corporate sector. Some of both kinds of misallocation is attributable to distortions in output arising from price effects to which consumers respond; some is attributable to shifts in factor intensities as firms respond to factor prices distorted by one or another aspect of the corporation income tax. Harberger included both of these distortions in his analysis of the effects of the corporation income tax on corporate and noncorporate sectors, but his analysis was highly aggregated.

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[1] Arnold C. Harberger, "The Incidence of the Corporation Income Tax," *Journal of Political Economy*, vol. 70 (June 1982), pp. 215–40.

Auerbach omits some of these distortions in his analysis—those arising from shifts in factor supplies because of changes in the remuneration of labor and capital, and in output because the corporation income tax causes shifts in relative product prices. In Harberger's terms, Auerbach omits the output effects of differences in the rate of tax across classes of capital goods. Because of this treatment, some of the distortions that would show up as changes in factor supplies or in the composition of output (if factor supplies and the composition of output were not assumed frozen) show up in Auerbach's model as distortions in factor inputs. If factor supplies could change, some shifts in the intertemporal pattern of consumption and in labor supply would occur. If composition of final output could change, production would tend to shift toward those commodities relatively intensive in tax-favored types of capital, thus driving up prices of types of capital used relatively intensively in expanding sectors—and at least some of these types of capital would be those that were tax-favored. As a result, demand effects would transmute some of the factor-use distortions into factor-supply and output distortions.

The remaining distortions arise for two reasons. Even if all output were produced by one firm, the tax advantages to one class of capital relative to another would cause a firm to alter its mix of capital inputs. Removal of those price distortions would permit the firm either to produce the same output with fewer inputs or to increase output. But Auerbach treats forty-four industries, rather than two, and thirty-four types of capital, rather than one. Because the technology of production differs among firms, tax provisions favorable to certain kinds of capital will cause a reallocation of capital and of labor, and output will be reduced. Rather than calculate the loss of output, one can start with the tax-distorted situation and enquire how much less capital would suffice to produce the observed output if the distortions were removed. This is the question that Auerbach answers.

The answer depends, among other things, on the size of the tax distortions and on the substitutability of factors for one another in production. On the size of the tax-distortions, Auerbach's answer is "very large, indeed." His table 4 shows enormous differences in effective tax rates by asset class. These differences translate into a 37.66 percent lower ρ for general industrial equipment than for industrial buildings. Auerbach assumes a Cobb-Douglas production function because it is mathematically tractable, not because it is descriptively realistic.

If one treats the entire corporate sector as a single firm with two types of capital subject to this degree of distortion in the required rate of return, one can calculate either the resulting loss of output or, equivalently, the amount of capital wastage that such a rate-of-return wedge would produce. Assume a production function, $X = L^a E^b S^c$, where L is labor, E is equipment, S is structures, and X is output, standardized so that no scalar is necessary in the production function. We know that roughly 80 percent of net value added accrues to labor and that the value of the quantity of net corporate equipment approximately equals that of net corporate structures. Given these quantities, the implied production function coefficients are $a = 0.8$, $b = 0.0768$, and $c = 0.1232$. Based on this production function and the rate-of-return advantage of equipment that Auerbach reports in table 4, profit maximizing firms would equalize the money value of equipment and structures in their net capital stocks. The rate-of-return distortion would reduce output by 0.54 percent, or, equivalently, it would imply capital wastage of 2.68 percent.

My second comment concerns the assumption of unitary elasticity of substitution. It is worth noting that, as Auerbach applies it, the adoption of a Cobb-Douglas production function is not equivalent to imposing a unitary elasticity of substitution among all types of capital. Because each industry uses only a few kinds of capital and the production function for each industry is defined only over those types of capital, Auerbach's Cobb-Douglas is equivalent to assuming a unitary elasticity of substitution among included capital goods and labor and a zero elasticity of substitution between each excluded type of capital and each included type of capital and labor. A poll of those assembled here would probably elicit a modal estimate of the average elasticity of substitution of capital for labor of about 0.75. We would agree that it is likely to vary across industries. Had Auerbach been able to use this value, his estimates of capital wastage would probably have been smaller than they are. But that leaves the question of what the elasticities of substitution among types of capital really are. We would again agree that they would vary among classes of capital and among industries, but I am not sure whether our opinions would place a weighted mean value nearer to 1.0, the assumed value for included capital goods, or to zero, the assumed value for comparisons involving excluded capital goods. The latter value would produce no change in the mix of capital inputs and no "within" distortion (see his table 6). I have no idea how a graph relating "within" distortion to the elasticity of substitution among types of capital would look, except at the end points. Nor do I know what the trade-off would be between "within" and "between" distortion.

In short, I am riding for all it is worth the discussant's famous dodge, the plea for sensitivity analysis. Some effort in this direction is essential because these estimates of distortion are important, and one needs to know how much confidence to place in them. To repeat, we need to know the consequences of different average levels of the elasticity of substitution among types of capital and of dispersion around that average. Even if we cannot estimate these elasticities, at least we can have some sense of how much our ignorance matters.

My third comment relates to policy implications of the empirical section of the paper. The section on the effects of incomplete loss carry-backs and delayed tax savings from losses that are carried forward (table 8) very nicely distinguishes the importance of this adjustment under three tax laws and at three rates of inflation. But there is no indication in the text accompanying table 6 or in table 6 itself of what changes in the corporation income tax, apart from total repeal, will go farthest toward lowering distortion. I strongly suspect, for example, that the idea advanced by two Harvard professors (one of whom, I think, has since left) for first-year capital recovery might go a long way toward reducing the wastage of capital. I fear, however, that that proposal may run afoul of Auerbach's analysis showing the unfortunate consequences of incomplete loss offsets, as first-year capital recovery, at least for a while, would drastically increase losses and possibly their dispersion as well.

Whether Auerbach's estimates of capital wastage are large or small, like beauty, is in the eye of the beholder. They certainly seem insufficient to explain the handwringing by both liberal and conservative economists over the distorting character of present rules for taxing capital income. The answer, I think, is that Auerbach in this article drops only one shoe.

The other is the personal income tax whose provisions for taxing capital income, together with institutional rigidities, cause additional distortions in the allocation of capital.

Robert E. Hall: Alan Auerbach has presented an interesting and imaginative account of a number of aspects of business taxation, covering some old ground and quite a bit of new ground. I would quibble a little with his title. The paper is really about the taxation of the earnings of corporate plant and equipment. There isn't anything about the interesting topic of taxation of other types of corporate earnings, and there is quite a bit about the taxation of plant and equipment earnings under the personal as well as the corporate income tax.

The paper shows very effectively what a monster the tax system has become, especially in the area of plant and equipment earnings. The system taxes the earnings of structures to subsidize equipment. Under the assumption Auerbach favors, the rate of subsidy on equipment is about 20 percent; the rate of tax on structures, about 30 percent (table 11). The full monstrosity of the system is not yet evident because the tax rate on existing capital is well above the rate on new capital. As time passes, the replacement of capital will erode the tax base. In later years, existing tax rates on structures will not be enough to pay the subsidy on equipment and generate current levels of revenue. All revenue estimates agree that the net revenue from the corporate tax will dwindle in the coming years.

The taxation of plant and equipment is like the old crude oil equalization tax. Under that tax, domestic production was taxed to subsidize imports. Now structures are taxed to subsidize equipment.

The deadweight burden of the unequal taxation of equipment and structures is not small. Auerbach calculates that the same output could have been produced with 2 or 3 percent less capital if the distortion favoring equipment were eliminated from the tax system. The forgone GNP is close to $10 billion a year.

The paper also puts a lot of effort into understanding the taxation of corporate income under the personal income tax. There are some very tricky issues in this area. At first, it would appear that the taxation of interest and dividends at rates of close to 50 percent under the personal tax would add quite a bit to the total effective tax rate on corporate income. However, Auerbach argues, as he has in other papers, that the taxation of dividends under the personal income tax makes no difference for effective rates on corporate income. When investment is financed by forgoing dividends now, the reduced current tax on dividends exactly makes up for the future tax on dividends financed by the return from the investment. The only personal taxes that matter are the accrual equivalent of the capital gains tax and the tax on interest income. On the margin, Auerbach argues, investment is financed mostly by equity through retained earnings, in which case the personal tax is just the capital gains rate of about 5 percent. Only about one-quarter of finance is through debt, and in that case the personal tax on the interest paid is between 20 and 40 percent.

This view brings up the murky issue of why firms pay dividends. The same firm contemplating cutting dividends to finance investment might just as well think about cutting dividends to retire debt or buy its own shares. Both unambiguously raise the value of the firm. The firm that was free to cut its dividend would easily find a reason to cut the dividend to zero.

A view with very different implications is that firms are precommitted to a certain growth path of dividends. Firms then decide between putting retained earnings into plant and equipment or into bonds. On the margin, all investment is financed by lower holdings of bonds or by issuing bonds.

Table 11 shows how sensitive Auerbach's findings are to assumptions about debt financing versus equity financing and about the tax rate on interest. If inflation is 4 percent, the subsidy rate on equipment is 46 percent if half of investment is debt financed and the rate of personal taxation of interest is 20 percent. On the other hand, if only a quarter of investment is debt financed and the tax rate on interest is 40 percent, the rate of subsidy is only about 7 percent. The tax rates on structures are 16 and 38 percent in the two cases.

My guess is that the effective fraction of debt finance is even above 50 percent because firms think of dividends as largely precommitted. I would also guess that effective taxation of interest income is not much above 20 percent. Opportunities abound for channeling interest to recipients in low tax brackets. Further, large amounts of interest income are simply unreported. The recent uproar over a modest withholding tax on interest suggests that many people think it is their moral right to escape taxation on interest.

Under my assumptions about the personal tax, equipment is heavily subsidized and structures are lightly taxed, but the qualitative conclusions of Auerbach's paper are not really changed—there is a major distortion because the tax system favors equipment over structures.

In today's tax system the federal government is pouring billions of dollars into subsidies of business equipment. Like all business subsidies, this one needs to be eliminated forthwith. Policymakers have been led to these heavy subsidies by a combination of trying to tax income and by having separate corporate and personal taxes. The fact that both taxes generate positive revenue conceals their pernicious subsidy of business equipment.

The most promising way to eliminate the gross inefficiencies of business taxation is to junk the current tax system and start again. A progressive consumption tax, administered as a value-added tax, seems the best avenue. It would guarantee effective tax rates of exactly zero on all types of investment, in place of subsidies and taxes as at present. All the efficiency and equity objectives of taxation can be achieved in a straightforward, administratively simple, and practical tax system. In that system, businesses and workers together would pay a tax based on the sales of consumption goods. Workers would receive the benefit of a graduated personal exemption, which could give the system any desired degree of progressivity.

General Discussion

Joseph Pechman questioned whether the differential tax rate on equipment and structures is the major factor responsible for the observed change in the allocation of capital. He noted significant tax differentials opened up only after 1972 whereas the ratio of investment in equipment to structures began a secular upward movement long before that. Pechman was not convinced that the tax system could fully account for this secular trend. Furthermore he was not aware of other evidence that there has been overinvestment in equipment.

Charles Schultze agreed with Pechman, arguing that the misallocative effects of the tax subsidies may be less for capital stocks than for other economic activities. If demand for investment goods is relatively inelastic to change in user costs, as suggested by the accelerator investment model, then the main effect of the subsidies is to increase firms' profits rather than the capital stock.

Jeffrey Shafer cautioned that there may be more equipment around than meets the eye: investment that is intrinsically related to structures may be fairly easily disembodied for tax purposes. While installation of central air conditioning is considered an expenditure on structures for tax purposes, installation of individual air conditioners that can be disconnected is considered equipment expenditure. A durable surface floor is an investment in structures, whereas carpets on the floor are an investment in equipment. William Brainard observed that there is considerable latitude in the classification of expenditures and that some of the reported changes may simply reflect more aggressive accounting practices by firms in response to tax incentives.

Several discussants argued that the discussion of the "misallocation" of the capital stock should recognize that social objectives other than technical efficiency are involved. George Perry suggested that the differential tax treatment reflected a desire to maximize investment stimulus per dollar of revenue lost. Congress, with the objective of increasing the capital stock and productivity, assumed that equipment was more responsive to tax subsidies than structures. Michael Lovell recalled Robert Crandall's argument that many members of Congress may favor equipment investment over structures investment because they want to encourage employment in the older industrial centers in the Northeast and Midwest by subsidizing plant modernization while avoiding the subsidization of plant movement to the Sun Belt.

John Shoven commented that the focus on the misallocation of capital within the corporate sector drew attention away from other distortions caused by the corporate income tax. Compared with the misallocations Auerbach focused on, Shoven's own work indicated that greater welfare losses from corporate income taxation came from the intertemporal misallocation of resources and from the misallocation of resources between the corporate and noncorporate sectors.

Representative **Long**. Thank you, gentlemen, for your excellent statements.

Perhaps both of you would comment on this, or either of you, if you prefer to. In my opening remarks I raised the question of the economic consequences of a consumption tax. Both of you have had some experience in studying this and I wonder if either of you have any evidence as to what it would mean to change the tax system from one based on income to one based on consumption? What would be the economic consequences of that?

Mr. **Minarik**. Well, in terms of incentives to save and invest, I think the answer is that on paper, in terms of the rate of return that would be available through alternative investments, there would be a higher rate of return to saving and investment.

In practice, in terms of what that would do to taxpayers' actual savings and investment practices, I think most of the evidence is that very little would happen.

The empirical work that has been done on taxpayers' response to changes in taxation in terms of saving and investment behavior suggests that they don't really respond an awful lot. I think that the results that we have seen thus far very tentatively from the 1981 tax law change clearly suggest that responses from taxpayers have been very small. The rate of saving in the economy, if anything, has gone down in response to substantial reductions in tax rates and substantial increases in depreciation allowances and, in some cases, investment tax credits.

Representative **Long**. Mr. Auerbach.

Mr. **Auerbach**. I think one point I'd like to emphasize is frequently ignored in the theoretical discussion of consumption taxes but ultimately will be, perhaps, the most important consideration. It is the issue of the transition to a consumption tax. It's not only important because it's a politically difficult issue to attack, but the economics of the consumption tax hinges on how the transition is made.

In particular, reference was made, I think, by Senator Bradley to the unfairness of consumption taxes in the way they treat perhaps the elderly, or people who have low incomes, who are now consuming out of savings they have been previously done. There are different ways that transition can be made to a consumption tax. One way would be a fairly draconian approach, to say you've got it and you're going to spend it and you're going to pay taxes on it. Another way is to say, in a sense, what we do under our current system of individual retirement accounts: if you've got previous savings, you can put it into an individual retirement account.

Representative **Long**. Let me ask you a question on that. In the 1984 economic report of the President, they treat that subject. They say:

> The new tax treatment of savings represents something far more basic than just an increased stimulus to saving. Universal availability of IRAs and the increase in IRAs and Keogh limits will allow most American taxpayers to pay tax only on that part of their income that they do not save. That is, only on the part of their income that they consume. Thus, for most Americans, the income tax system is now virtually transformed into a consumption tax.

Mr. **Auerbach**. Well, I think that's something of an overstatement, but there's a point well taken which is that individual retirement accounts and Keoghs, as they have been expanded and may be expanded again, do provide consumption tax treatment. The important point here is that a lot of the savings that's receiving the benefits of individual retirement accounts is savings that was done long before these provisions were enacted, and if we enacted a consumption tax where we similarly allowed consumption out of existing assets, say by the elderly, to avoid taxation, perhaps for reasons of fairness—and one could certainly argue for that—that's going to reduce the tax base substantially and require much higher rates on the remaining tax base; namely, labor income. Despite what may happen to increase savings, there may be negative effects on labor supply. Research that I've done suggests that, whether a consumption tax is efficient or inefficient relative to the current tax system depends largely on how low the rates can be made and that, in turn, depends on the transition.

Representative LONG. How far do you want to go? Go ahead, Mr. Minarik, and then I'll ask my question.

Mr. MINARIK. I was just going to add one more thing, Mr. Chairman, and that is, if we now have a consumption tax, it's the worst consumption tax imaginable to the mind of man. Not only is there a problem that Alan mentioned with people moving savings that they did before on a non-tax-preferred basis into an IRA and getting a deduction for something they did in 1952, we now have the opportunity to borrow and put money into an IRA and get a deduction for that.

I have a letter I carry around in my briefcase from a local bank inviting me to borrow $2,000 to put in my IRA account.

Representative LONG. I've seen those ads in the newspapers inviting you to come borrow $500 and open your IRA account.

Mr. MINARIK. This is not what I would call an efficient consumption tax.

Representative LONG. Is there a limit on how far you want to go to encourage savings?

Mr. MINARIK. There certainly is. I think there is an analogy that you could have in looking at the income tax with respect to our economy. I think in 1981 in the debates that led to the passage of ERTA it was suggested that somehow the income tax could be a turbo charger that would push the economy faster. That is not the case. Any tax that we are going to impose is going to involve distortions and, therefore, it is more like a hurdle over which the economy has to jump. I think that the approach that is taken in the Bradley-Gephardt bill is to reduce the size of the hurdle. It's inevitably going to be a hurdle and you're going to have to have something there, but you can get it to the point where pretty normal strides can get you over it.

What we tried to do in 1981 was to completely eliminate the hurdle, and instead of winding up with a level playing field, we had a 6-foot trench. We've lost a lot of businesses down that trench in terms of the results with respect to the deficit, higher interest rates and, in addition to that, we have had a lot of waste. That trench has become a tax shelter.

On the question that you asked earlier, Mr. Chairman, I'd like to emphasize what Senator Bradley said. When the administration said that lower tax rates were going to reduce tax shelters and tax avoidance, they even asked for a reduction in IRS funding because it wouldn't be needed back in their revisions of the fiscal 1982 budget. The reason was that we completely offset that with what we did to the accelerated cost recovery system. With the one hand, in reducing tax rates, we made shelters less profitable; with the other hand, what we did with ACRS was to make them even more profitable than they were before. We wound up worse off.

So I'm suggesting let's have a small hurdle rather than a trench in the path of our economy.

Representative **Long**. Congressman Hamilton.

Representative **Hamilton**. Thank you, Mr. Chairman.

One of the things that strikes me is that we have a great big complicated economy and, of course, the Tax Code affects it enormously in many, many ways. Despite the problems in the economy, it has served most of us reasonably well and is a great pride to most Americans.

We talk about the strength of the economy all the time. If you look at the performance of the economy right now compared to the economies of the rest of the world, we are doing pretty well, despite our problems.

Now you come along with a major change along the lines of the proposals that we have been talking about this morning. You have to be concerned not only on how the tax affects individuals within the economy but you have to be concerned about what the impact is going to be on the total economy of the United States.

My question is, how accurately can you experts measure all that, or is it in a sense a kind of shot in the dark? Congressman Gephardt said a moment ago, well, we will do this and if we don't like it we will change it in 2 years. But you know it's an extraordinarily difficult thing to change the Tax Code, even in a minor way. So how sure are you of the macroeconomic effects of this kind of a change?

Mr. **Auerbach**. I think one can be much more certain of the allocational effects than the overall effects. Let's take the behavior of corporations investing or farms, if you like. It's pretty clear that the very, very big differences in incentives to invest lead to distortions in the allocation of capital. Changes that we have observed over time suggest that these differences do have a strong influence and that reducing them will greatly alter the mix of capital.

Similarly, I think it's fair to say that a strong reduction in the marginal rates and a deceleration of depreciation deductions will reduce the profitability of tax shelters and, hence, reduce this form of activity at the personal level.

My view is that going from that and from the obvious distributional impacts of a change in the tax law to saying that there will be more or less saving, or more labor supply, or more investment, is a lot more difficult, in part because the evidence is not that strong that the overall macroeconomic impact, as opposed to the allocational and distributional impacts of taxation, is that big. Anybody who says that they are certain what these policies are going to do is simply being disingenuous.

Mr. **Minarik**. If I could add to that just a second, I think there are a couple of things I would say. One is, as Alan points out, we know from past experiences, including the experience of 1981, that people basically want to work, they want to save and accumulate some wealth, and the tax system can affect what they are going to do in those regards marginally, but it's not going to make an awful lot of difference.

I think that there's an important point here. We know that we don't like the current tax system, and if we want to change it, you have to come up with something different. You also know that if you don't want to rock the boat, either in terms of tax administration or in terms of the economy, you have to stay somehow within the scope of the present system. The more radical the change, perhaps the better chance you have of doing something better, but the more chance you have that you're going to rock the boat too seriously to be able to get there without causing some problems.

I think that what is notable about Bradley-Gephardt is that it makes measured changes in specific areas to push the tax code in a direction I would say is more productive, but it does not make the radical changes like going to a consumption tax or going to a straight flat-rate income tax that might cause problems of transition and problems of dislocation.

Representative **Hamilton**. Do both of you feel that the American economy—macroeconomics now—would perform better under Bradley-Gephardt than under the present tax code?

Mr. **Minarik**. I would be willing to say that it would perform better. I think it's highly uncertain how much better it would perform. I think the best way to look at that is to say that it could come closer to its potential than it would. I don't know how much we can determine what that potential is.

Mr. **Auerbach**. My view at this point is that the most important issues for the performance of the macroeconomy in the next few years have to do with the size of the Government deficit and the monetary policy that's followed, I think this is a secondary issue.

Representative **Hamilton**. Have you had an opportunity to look at the Kemp-Kasten bill?

Mr. **Minarik**. I have looked at it some.

Representative **Hamilton**. How would you describe the advantages of Bradley-Gephardt over Kemp-Kasten? I'm assuming that you see advantages in it. I may be retracting that later.

Mr. **Minarik**. I think I could say the same things about flattery that have been said twice before. There's a great deal of similarity. As I looked over it, I tried to make some notes of some of the differences and how I would evaluate them.

I guess that I have questions as to how fair the FAST tax is and how simple it is, as well. There are a couple of things it does that I think are troublesome. One thing that Kemp-Kasten does is it scales back the refundable earned-income tax credit for low-income families with a working head, and that, I think, is troublesome.

It repeals the extra exemption for the elderly, and I tried to work out some things of what the implications of that would be just for the fun of it. An elderly couple claiming the standard deduction with a $15,000 income under current law would pay $959 of tax. Under Kemp-Kasten, they would pay $1,375. So, in other words, more than $400 more. At $20,000, under current law, they would pay $1,741; under Kemp-Kasten, they would pay $2,625, almost $900 more.

Representative **Hamilton**. These are low-income people?

Mr. **Minarik**. These are moderate-income elderly people. And that may be one of the things that they had to do to try to approach the revenue constraint. The problem there is that for elderly people, if you take their extra exemption away, they have less income they can earn free of tax and they go right into Kemp-Kasten at a 20- or 25-percent tax rate. So that's troublesome.

On the upper end of the income scale, I don't believe it was taken into account in doing the revenue estimate—I can't believe that it was—but there's created in Kemp-Kasten what I would have to say has got to be the granddaddy tax loophole of them all, which is to say that taxpayers who sell capital assets at a loss can take an unlimited deduction of their capital losses against ordinary income. Under the current law, we have a $3,000 limit.

The reason for that is that someone with a very large store of wealth in a diversified portfolio could sell assets that depreciate in value and take losses on a realization basis that would wipe out all of his other income. He just wouldn't trade the asset he had that went up in value.

I worked out what that would imply. In 1981 income level, which of course means the dollar numbers are too low, that one provision would lose $4 billion, and that's assuming no change in taxpayer behavior. Obviously taxpayers would realize a lot more losses if they could get a complete deduction against ordinary income.

As far as the simplicity end of it is concerned, I'd be concerned about the different treatment of earned income and unearned income. That causes problems. At different income levels, earned and unearned income are taxed at different levels. Below $40,000 earned income is taxed at 20 percent, unearned income is taxed at 25 percent. Between $40,000 and $100,000, unearned income is taxed at 25 percent, earned income is taxed at 28.125 percent. So taxpayers will be trying to jockey income between one category and another.

Representative **Hamilton.** Do you like or dislike the indexation feature.

Mr. **Minarik.** I do not like indexation as a matter of principle. It seems to me that you're taking great risks of building inflation into the economy, and it seems to me that, given that, it is easier to pass a tax cut than it is to pass a tax increase. You are safer if you have that kind of a lid on excess demand inflation than you are in having automatic tax cuts perhaps at times the economy is overheating.

Representative **Hamilton.** Mr. Auerbach, do you want to tackle my general question on the Kemp-Kasten bill?

Mr. **Auerbach.** Well. I'm not nearly as familiar with it as I am with Bradley-Gephardt. I also have some questions about whether they would raise enough revenue to keep the system at the same level of revenue. They haven't attacked the problems of distortions at the corporate level at all, as far as I can tell. So it certainly seems probably to be closer to a flat rate tax in the sense that rates at the low end start higher, and it seems to attack fewer of the problems that exist in the current tax law.

I do think—I will repeat—that indexing is a good idea. My view is that the macroeconomic consequences of making the economy more prone to inflation are minimal. The unintentional or unplanned changes in people's tax brackets that have occurred over the years, before indexing was enacted in 1981, altered the average tax rates of people in different income class in a way that I don't think ever would have been enacted. And I think that's a good reason for indexing.

Mr. **Minarik.** May I just add to that? Recognizing that Alan and I would agree to disagree on the fundamentals, having a flatter tax rate schedule with broader brackets means that the effects of inflation on a Bradley-Gephardt-type system would be much smaller than they are under the current multibracket system in which there's a great deal of graduation.

So if you like indexing but you think for one reason or another you can't do it, I think the Bradley-Gephardt is the next best thing.

Representative **Hamilton.** Under Bradley-Gephardt, would it be fair to say that we would pretty well put out of business the tax shelter industry?

Mr. **Minarik.** I think it would be greatly reduced. About the only thing that would be left would be trying somehow to move your income from December of one year to January of the next year so you could postpone your tax liability for a year. But the business of straddles which we're now dealing with under the current law is made even more attractive now by the long-term, short-term distinction with capital gains, and if you eliminate that under Bradley-Gephardt you at least take some of the shine off of tax writeoffs.

Representative **Hamilton.** Are you concerned at all about the impact of Bradley-Gephardt on investment?

Mr. **Minarik.** Absolutely not. On the capital gains question, I think that it's important to take that into a broader view. The tax rate on long-term capital gains goes up from 20 to 30 percent under Bradley-Gephardt. The tax rate on short-term capital gains goes down from 50 to 30 percent under Bradley-Gephardt. Taxes on interest and dividends, maximum rates go down from 50 to 30 percent.

Representative **Hamilton.** Is that a good thing, to move down on short-term and up on long-term capital gains?

Mr. **Minarik.** It's a good thing for the tax system because you don't have the kinds of straddle activities I was discussing earlier. It really doesn't make much difference from an economic point of view if a corporation sells shares of stock today and uses the money to go out and buy a machine, and then if the people who bought that stock sell it 2 weeks from now. The corporation does not have to give the machine back. What is important is that the money was put into the equity in the first place.

The distinction between long-term and short-term gains was mostly there to prevent people from taking advantage of the capital gains exclusion so that they would pay tax at a 60-percent lower rate if they only held a stock for 2 weeks. If you eliminate the exclusion, there's no reason to worry about some long-term, short-term distinction.

Representative **Hamilton.** Well, Mr. Chairman, these witnesses have been very good and helpful. I appreciate it very much.

Representative **Long.** Thank you very much.

Mr. Auerbach and Mr. Minarik, we appreciate the effort you both put into preparing your testimony and coming here today to share it with us. I commend you and I thank you.

This subcommittee stands adjourned.

[Whereupon, at 11:35 a.m., the subcommittee adjourned, subject to the call of the Chair.]

FAIR TAXATION

THURSDAY, JUNE 14, 1984

Congress of the United States,
Subcommittee on Economic Goals
and Intergovernmental Policy of the
Joint Economic Committee,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:15 a.m., in room 2203, Rayburn House Office Building, Hon. Lee H. Hamilton (chairman of the subcommittee) presiding.

Present: Representative Hamilton.

Also present: James K. Galbraith, deputy director; and William R. Buechner and Christopher J. Frenze, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, CHAIRMAN

Representative Hamilton. The meeting of the subcommittee will come to order.

Today is the second day of hearings on the subject of fair taxation, being conducted by the Subcommittee on Economic Goals and Intergovernmental Policy.

The purpose of these hearings is to examine alternatives to the current U.S. tax system. Yesterday we heard testimony from Congressman Gephardt and Senator Bradley, whose fair tax would repeal most deductions and exemptions except those generally available to most taxpayers, while at the same time establishing a progressive tax rate structure with rates much lower than under the current system.

Today we are pleased to welcome Congressman Jack Kemp. Senator Bob Kasten, I understand, will be with us a little later. They recently introduced their fair and simple tax, or FAST tax, which is also a broad-based income tax but with a single flat tax rate. In many ways it is very similar to the Bradley-Gephardt fair tax but it differs in a few significant aspects, and we'd like to explore those similarities and differences today.

Congressman Kemp and Senator Kasten will be followed by two distinguished tax experts, Richard Musgrave, professor emeritus from Harvard University and currently visiting lecturer at the University of California at Santa Cruz; and Edward Gramlich, professor of economics and public policy at the University of Michigan. They will examine the impact of tax reform on the economy.

Congressman Kemp, we are very pleased indeed that you could join us this morning and we are delighted to have you. Your statement, of course, will be entered into the record in full, and you may proceed as you wish.

STATEMENT OF HON. JACK F. KEMP, A U.S. REPRESENTATIVE IN CONGRESS FROM THE 31ST CONGRESSIONAL DISTRICT OF THE STATE OF NEW YORK

Representative KEMP. Thank you, Mr. Chairman.

Many thanks from many people for holding these hearings. It is critical to the future of this country that you, Mr. Chairman, and your committee study this issue as you are doing, give the issue of the tax reform the type of serious and candid deliberations that it deserves. And, of course, the administration is studying this. As you mentioned, Senator Bradley and Congressman Gephardt and many in your own party have talked about lowering rates and broadening the base. There are many in our party. And, of course, the candidates for the President in one form or another have talked about tax reform.

Unfortunately, it's like the weather. Everybody in the past has been talking about it and not much has been done. But if the campaign in 1984 revolves around tax reform and we have a national debate, hopefully some consensus can develop and we come back—although the hour is late, it is not too late to bring about the type of a tax system that will bring rewards back to working Americans as well as those who want to save and invest.

Although some steps have been taken in the past, much more needs to be done. We can broaden the base, we can lower the rates, and we can leave in major deductions for the middle class and the poor, and I think either be revenue-neutral, Mr. Chairman, or because of the fairness of the new code and the simplicity of the new code it would allow for the underground economy to drop, and we could recapture some of that hundred-or-so billions of dollars that are now escaping taxation by virtue of the fact that the American people overwhelmingly believe that the system just isn't doing what it was designed to do, and that is to raise revenue, to be efficient, and to provide incentives for people to be as productive as they humanly can be. So your hearings are really a large step in the right direction, and I want to congratulate you.

Second, I appreciate the chance to put my prepared statement in the record. It is lengthy and it is for the record. I would like to go through a rather brief summary and then get to questions and answers, not only about the Kemp-Kasten bill but about Bradley-Gephardt and the juxtaposition of the two and what can be done in the near future.

I am convinced, Mr. Chairman, if I can just make a brief further statement, that we need to reform the way we tax people's money, we need to reform the way we spend the people's money, and we need to reform the way we value the people's money. So we are entering, I think, one of the great reform periods of our Nation's history. And I look forward to participating with you, Mr. Chairman, as someone who has taken an interest not only in fiscal but in monetary and tax policy as well.

Having said that, let me begin by saying the case against the current system is just overwhelming. I don't know of anybody who is going to come before this committee and defend the current income tax system, either for the corporate or the personal or the combination.

The system is failing in what is was designed to do, and that is to provide equity, efficiency, simplicity and, I want to repeat, raise revenue. The purpose of a tax system is to raise revenue.

I have been accused in the past of wanting to cut taxes so we could lose revenue to get spending down. I want it cleared up, Mr. Chairman. I think the tax system should raise revenue. There are many important goals for this country that cannot be met other than by a tax system that is fair, equitable. It should be distributed according to people's ability to pay.

And, fourth—and this is a maxim that comes out of Adam Smith and all other great classical economists—taxes should never be raised to the point at which it discourages the industriousness of its people. At that point, I think it becomes counterproductive. The whole debate was simply the recognition that in the beginning, in the classical sense of the word, there is a point of diminishing return to taxes as there is to prices or any other thing under consideration. There are many of us who still believe that the American people are not undertaxed, they are still overtaxed, and that in large part is causing not only some of the pain out there among people but is causing some of the inefficiency in the Tax Code.

It needs major overhaul. I don't think piecemeal reform will do it, Mr. Chairman. It seems to me we have to think in terms today of a whole new system, notwithstanding some of the transition problems that may occur. We must take ourselves out of the realm of thinking of a new tax system as a progression. We've got to think about it almost in a radical sense of a new tax system imposed on behalf of the American people to encourage them to be more productive as well as to provide for a greater degree of savings and investment, as well as to lower the cost of labor, and of course raise revenue, which I keep pointing to.

The Kemp-Kasten bill, I think, Mr. Chairman, while not the final word, is at least one of the early words in this debate. I appreciate very much—and I have said this publicly—what Senator Bradley and Congressman Gephardt have advanced. I think that has been very helpful. I have some problems with some of the aspects of their treatment of, say, the capital gains. I think they made a similar mistake in going back to the pre-1981 depreciation schedules. I think indexing is a very important point, not only for capital gains but for personal income. I don't want to go back to the pre-1981 depreciation schedules. We ought to think of a better depreciation schedule for America's small, medium, and large businesses.

Having said that, however, I think the debate has been started by probably Bill Steiger back in 1978—and supported by you, Mr. Chairman, and me and a lot of others—when he said we should bring down the 49-percent capital gains tax rate to increase equity and venture capital of this country. I think you could make a case, Mr. Chairman, that the equity markets and the venture capital markets were positively impacted by the lower capital gains rate, then the lower corporate rate. And, of course, I have been interested over the past 8 years or so in lowering the personal income tax brackets or rates, not unlike what President Kennedy did in the early 1960's when he cut the rates by 30 percent across the board.

Our tax rate system, the acronym of which is FAST—fair and simplified tax system—takes the top rate down to 25 percent on personal income. It leaves major deductions, Mr. Chairman. Briefly, we leave in the interest paid on mortgages; we leave in real estate taxes; we leave in charitable contributions; we leave in IRA accounts and Keogh accounts to encourage people to privatize their pensions or to encourage savings; we leave in major medical expenses. We think those are broad social goals for this country and deserve retention in our Tax Code.

But even though the rates are lowered to 25 percent for personal income and 30 percent for corporate income, and even with those deductions, and even with an increase in the exemption for families, the Joint Tax Committee, Mr. Chairman, says that Kemp-Kasten, on a static analysis—that is, without taking into consideration any of the dynamics of what would happen to people's incentives to earn or work or save or increase their production or take money out of shelters or liberate some of the loopholes and put it into more productive investment—even without taking into account the dynamics on a static basis, our tax reform is generally revenue-neutral.

It also, Mr. Chairman—I want to say this at the outset—leaves the distribution of the tax burden relatively the same as it is today. One of the problems we know we get into when we look at a flat tax is that in effect you are lowering the top rates and you're raising the bottom rates. You are lowering taxes for the so-called rich, in a static sense, and raising it for the working poor.

The way around that—and it has to be done, Mr. Chairman, because again we must protect this broad, general consensus in this country that taxes should be predicated on people's ability to pay—it seems to me the way to get to that is either by the graduated nature of the Bradley-Gephardt flat tax—I know that sounds paradoxical but they've got generally a flat-tax principle with a couple of brackets in there to bring about some progressivity.

I recognize this problem, as did Senator Kasten, and as do many of the cosponsors of our bill, that you couldn't take the working poor—you wouldn't want to take families, you wouldn't want to take the men and women who relied upon their income to purchase goods and services and food and fiber for their families and raise them to the same bracket that is otherwise paid by relatively well-off Americans. So what we did in solving, I think at least in large part, this conundrum or this paradox or this dilemma, we put in a large earned-income tax credit. So the first 20 percent of an individual's income is exempt from the Personal Tax Code, and then we phased it out over $40,000.

Let me make a couple of points beyond that. Not only do we double the personal exemption for each taxpayer, spouse, and dependent to $2,000; we also index it. I don't have this in my testimony, but I just was reminded of the fact that when Harry Truman and the U.S. Congress in 1946, I think, Mr. Chairman—I wasn't here; you weren't here——

Representative **Hamilton**. Neither was I—not quite.

Representative **Kemp**. In 1946 I think it was the Heritage Foundation that did a study of the exemption, and I think it was $600 in 1946. I could be off by $100, but I think it was around $600, and it wasn't raised until 1981 or 1982. In 1946, if you took the $600 and totally indexed it for inflation up until today, it would be well over $2,000, maybe $2,500. If you had indexed it not only for inflation, Mr. Chairman, but if you had indexed the personal exemption for the amount of income per capita that it represented in 1946, today it would be $5,600 for each member of the family.

Now, we had a strong bias in this country from its beginning, but particularly at the time of the post-World War II period and the recovery, that the family and the ability of that family to earn income and to send children to college or to save for a rainy day or to buy a home or to otherwise develop that nest egg that gives them a share in the American capitalist pie, if you will, has been diminished not just by inflation but by the fact that we have seen the cost of living rise, the exemption diminish, not only against the cost of living but also diminish against the amount of income per capita that it represented in 1946. We double it to $2,000 and then we index it. There's a lot of debate over that, but I think a family of four, for instance, under our bill would not pay any tax on income up to $14,600 or $14,700.

Now, that is important because right now a working family with two children—if that family, say, came off welfare, the welfare system works in such a way that you lose welfare if you go to work, and the Government taxes your income if you go to work. And I found out the other day that a family of four in Los Angeles, CA, or in New York City, counting up the State, city, county, Federal transfer payments income, if a family of four gets about $8,000 of nontaxable income from transfer payments for their welfare, counting food stamps, housing allowance, AFDC, et cetera, et cetera, and then the mother or father gets a job, the combination of the lost welfare and the tax on their earnings, counting the payroll tax and the income tax, nets out no increase in the aftertax reward for getting a job, say, of an equal amount of $8,000. In other words, there's a 100-percent marginal income tax rate on the inner-city poor who are on welfare and want to go to work. That is a large disincentive.

Some economists, Mr. Chairman, say we should tax the welfare benefits, we should tax unemployment benefits, we should tax the nontaxable sources of income. Well, I guess you could create a disparity between income for not working and income for working by taxing the transfer payment. It seems to me a better way to do it, Mr. Chairman, would be to exempt low-income working families from paying any tax until they earn enough income so they can begin to see their better shot at the American dream was in taking a job and earning that income and beginning to take care of themselves, which is what the vast majority of the American people want to do. Ninety-nine percent of the American people, as you know, from Indiana, and as I know from Buffalo, NY—I saw a picture in the Buffalo News a few months ago of 10,000 people lined up, in the rain, for 39 jobs at Anaconda Copper in Tonawanda, NY—10,000 people, the majority of whom, I'm sure, were in the inner city, who were minorities.

People want to work, Mr. Chairman, and we have got to find a way to create incentives in the tax system to give them that reward to provide the opportunities, to encourage entrepreneurship, and to keep our economy growing in a noninflationary environment. We simplify the Tax Code. We broaden the tax base, Mr. Chairman, by eliminating most tax preferences or loopholes, as they are commonly called. But we, as I said, have retained important deductions for interest, including mortgages, charitable contributions, real property tax, major medical expenses. We have also retained the current tax treatment for IRA's, Keoghs, Social Security, and veterans' benefits.

I guess one man's or woman's loophole is someone else's tax expenditure. But I think, Mr. Chairman, we could make a case, as I think the Bradley-Gephardt bill also does, that there are some broad social goals that this country has that can be met probably, or facilitated, at least, by the tax system.

I mention that our tax system, I think, helps families. The Tax Code in the past has penalized families. We think ours builds up family income and gives working families, particularly, a chance to earn more income without having it taxed before they get into brackets that were at one time reserved for David Rockefeller.

We index the Tax Code. I think indexing is important. A lot of people don't understand it, Mr. Chairman. It is keenly debated but, frankly, indexing was a part of Kemp-Roth in the beginning. It was part of the President's tax system reform of 1981. It is broadly supported on both sides of the political aisle. I would retain indexing of not only personal income but also take it further and index capital gains rates.

I think the Bradley-Gephardt bill, parenthetically speaking, makes a mistake in taking indexing out because pretty soon those people, Mr. Chairman, at 4-percent inflation, in the 14-percent beginning bracket of the Bradley-Gephardt bill, will be in the 30-percent bracket before they know it.

And that is what was happening in this country. The explosion of inflation in the 1970's impacting upon the steeply progressive income tax rate system was pushing the worker and the saver into higher and higher brackets to a point where, Mr. Chairman, by 1979 or 1980 we had figured out that the aftertax income for the working, average manufacturing wage family in America was lower in 1979–80 than it was in 1969. The combination of taking nominal incomes into higher brackets but lowering the purchasing power of the dollar, coupled with, as I say, the higher bracket, had taken the average manufacturing wage of the average auto and steel manufacturing worker in this country into such high nominal brackets that he or she was earning less money after taxes and inflation in 1980 than they were earning in 1969.

Incidentally, Kemp-Roth lowered the rates by 30 percent. If you had adjusted the brackets of all the American people for inflation since 1970—I came in 1971; you were elected in——

Representative **Hamilton**. 1964.

Representative **Kemp**. Well, if you adjusted the brackets since I came to Congress, you'd either have to cut the tax rates by 50 percent or raise the threshold at which people reached the brackets by 110 percent.

If we had done it since you came to Congress, Mr. Chairman, to get back to the 1964 Tax Code, we'd have to have cut tax rates by 60 percent or raise the threshold by 130 percent. That is what happened to working families. That is what happened to savings. We wonder why savings went down. They went down in large part because the aftertax rate of return on savings was dropping as the value of the dollar declined and the tax bracket into which savers were pushed was rising with this impact of inflation on a very steeply graduated tax system.

We improved the corporate tax code. Let me just take a minute on corporate taxes. We repealed most of the corporate preferences, Mr. Chairman, and we lowered the rate from 46 to 30, as does the Bradley-Gephardt bill. We reduced the rate to 15 percent for small business, and the new depreciation schedules are retained.

I think you can make a case that the 1981 depreciation schedules—some say it was too generous to business; others say it wasn't generous enough. But I think this recovery will point to the fact that at least we took some marginally progressive steps in 1981 to encourage capital formation on the premise, Mr. Chairman, that the only real and lasting way to increase the productivity of a nation is to increase the amount of capital invested per worker. The higher the amount of capital investment per worker, the higher the production. Ultimately wages must be paid out of production, so a higher product through more capital investment, as Japan has found out, will increase earnings and wealth and income and wages without inflation, if monetary policy, of course, is stable. And that is, of course, another issue which I testified before this committee on last week.

Incidentally, in Japan their depreciation schedules are far more—I am going to use what some people say is a liberal word; I think it's not liberal or conservative; I think it's a very good word—they have a far more progressive depreciation schedule. They allow you to invest in a new piece of machinery, a new piece of technology, a new piece of equipment, a new plant, at a far faster rate of depreciation. Irrespective of that, in Japan you can save $40,000 to $50,000 a year. In the United States we give you a $2,000 IRA account, and if you ever cash it in we just nail you to the wall at the State, local, and Federal level. We should be encouraging more savings, not only by business, but most important, we should be encouraging savings by small businessmen and women, and particularly by persons, by the people of America. They love to save if there's a reward for it. We need to restore that reward.

I mentioned our revenues are static. I think basically you will find, after this is analyzed, that a family of four around $20,000 will get a tax cut of about $616. I hate to get into this, because I think it's a mistake. If you start saying which family is going to get how much of a tax cut in the first year, you have also got to take into consideration, Mr. Chairman, under Kemp-Kasten, that if he or she starts to earn more income, that individual man or woman or that family will never pay on the personal income tax bracket more than 25 percent. That is an encouragement to earn more income. That is what the American dream, to a certain extent, is all about.

Our average tax rates remain approximately the same but marginal tax rates are cut dramatically. We think this will reduce the tax wedge. I mentioned the tax wedge on the inner-city poor. I want to briefly mention the tax wedge on workers. The cost of labor, the cost of hiring somebody, is not just the income that you pay that individual; it is also the tax that he or she pays. There is no worker in Buffalo, NY, who is working for what they can pay in taxes. Workers from Indiana to Buffalo, NY, work for what they can take home.

They don't work for their pretax income, in other words, as you know, intuitively; they work for what they can take home. So the cost of labor has to be measured not only by what people earn, but by the tax system.

In Japan, a steel company pays $116 of income to a worker in order for that worker to earn $100 after taxes. In the United States, Bethlehem Steel, who left Buffalo several months ago, was paying $190 to get $100 of after-tax income for those workers. Bethlehem Steel was complaining about having to pay so much, the workers were complaining about not getting enough income to live in this country, and the wedge that was driven between the reward for working and the cost of hiring somebody is what we call the wedge. And the wedge on inner-city income is outrageous. It's 100 percent, as I pointed out earlier. The wedge on labor is very high, is driving up labor costs.

I think by bringing down the corporate and the personal tax rate. Mr. Chairman, either under Kemp-Kasten or Bradley-Gephardt, or other flat taxes, one of the major benefits will be that we are going to lower the cost of labor against competitive countries in world trade, and we are going to make American labor more competitive without having to take away the earnings that they are in desperate need of, even though some people point to their wages as a cost of inflation. In other words, they could settle for lower wage contracts if they could get more after-tax income and not have to see it eaten away either by going into a higher bracket or by seeing inflation drop the value of their after-tax earnings.

I mentioned the corporate income tax rate. I will close on this.

I think, frankly, our tax system will not only help labor-intensive companies and small businesses; I think it helps to be able to use the 1981 capital cost recovery provision.

We reduced the corporate from 46 to 30 percent. There's a big debate, Mr. Chairman, over the investment tax credit versus a lower corporate rate. I must admit this is going to be a hotly contested item. Some companies that are capital-intensive would rather have a high marginal rate and a higher exemption or a higher tax credit. In fact, I've met some people in certain industries—real estate speculation, Mr. Chairman—who would rather have the tax rates back at 70 percent, and then give a deduction for building condominiums in Florida. I shouldn't pick out Florida, but I think you could point to the tax system distorting the decisions that were made in the 1970's toward real estate speculation—and I'm not against people investing in real estate, nor are you, Mr. Chairman, but the decision to invest should be predicated upon the economic consequence of a decision, not upon the tax consequence of a decision. And I think the tax reforms to which we are alluding today are going to provide a more efficient economic decisionmaking process as opposed to just looking for tax consequence.

We significantly reduced the double taxation of corporate income. I think everybody knows that this is a problem that both Democrats and Republicans. Liberals and Conservatives, Business Roundtable as well as the ADA, would like to eliminate the double taxation in dividends. I must admit it is difficult to do it because on a static revenue basis, Mr. Chairman, it shows a big, huge loss of revenue to the Federal Government. We reduce, however, sharply the double taxation of dividends. I think that would encourage savings. It would also help provide a flow of capital back into our economy that will keep this recovery going without inflation if again we can get a monetary policy that is based upon something more stable than just the latest rumors about what the Federal Open Market Committee did at its last meeting, which is one of our problems today.

Incidentally, to show you a most unbelievable—I couldn't stand up in a 1-minute speech because I had to rush over here, but what I was going to say was—this is 1984—if you thought 1984 is here and George Orwell was right on other issues, I thought you'd like to hear the opening line of a New York Times column by a friend, and someone whom I have a high regard for, Leonard Silk—I want you to listen to this, Mr. Chairman. He says:

> The United States economy is expanding so strongly it is driving up interest rates and alarming the stock market.

In other words, the stock market is being impeded by a strong economic recovery, and it would slow down the recovery; there will be less drain on the credit markets and that will bring down interest rates so we can grow again.

Unfortunately, that view is compounded by the fact that it is also the orthodox view of the FOMC at this very moment, because in March they tightened up interest rates and credit conditions because they thought the economy was overheating.

Well, the economy is not overheated. According to any market I can look at, the dollar is strong against every currency; productivity is up, which is one of the reasons I think the 1981 tax level was the right thing to do; the dollar is strong against the deutsche mark, the Swiss frank, the yen. And it seems to me this view that you can create inflation or engender inflation by growing too fast is the enemy of both our parties, and certainly it is the enemy of the people of Buffalo because there is far too much unemployment in Buffalo, as I know there is in Indiana. I think the tax policy is only one aspect of this.

I have talked far too long. I want to get a couple of debating points in just to wake everybody up, Mr. Chairman. I appreciate again your hospitality, and I look forward to working with you.

I'm glad there's an election. Let me finish by saying this. We have kind of reached an impasse in the House. Let's face it. Politics is here. November is right around the corner. We can't seem to get certain things done. I know you're a great supporter of bipartisanship, but it seems as if we have come up against loggerheads for whatever reasons. But knowing you're a man of the center, as am I, it seems to me the election is going to be healthy for this country, and I look forward to it. I think a debate over this issue is going to be healthy for you and me, and it will allow American people to once again in this democracy speak to us as to what they want done. And I say to them, if they want their taxes increased, don't support me.

[The prepared statement of Representative Kemp follows:]

PREPARED STATEMENT OF HON. JACK F. KEMP

Kemp-Kasten: Reforming the Tax Code

Introduction

I am pleased to testify today before the Joint Economic Committee. This committee perhaps has done more than any other Congressional committee to shift the focus of economic policy away from austerity, high inflation, and the Phillips curve and towards economic growth, incentives, and productivity. The JEC, in fact, gave us Reaganomics, before Ronald Reagan. Way back in its unanimous 1979 annual report, the JEC outlined a bold vision for economic policy: Policymakers must "alter the policy mix to encourage supply, reduce disincentives, and raise the reward to production." This economic policy--which became reality under President Reagan --has been responsible for the strong economic recovery we now are enjoying.

By taking leadership on the next round of major tax reform, the committee is once again in the forefront of sound economic thinking. In my judgment, fundamental tax reform which lowers marginal tax rates and broadens the tax base should be the pro-growth fiscal policy issue of the 1984 electoral campaign. It should be the cornerstone of this Administration's economic policy. Whichever Party and whichever candidates position themselves on the cutting edge of this issue, will be rewarded with the leadership of the 1980s.

Congress and the new Administration could spend the next four years tinkering with the tax code--eliminating a tax preference here and plugging up a tax loophole there. Or it could sweep away the existing system and try a wholly new approach, gathering support from within both political parties and winning the thanks of 100 million taxpayers, many of whom now believe that the federal income tax is the unfairest tax of all. The better and bolder way is to tax people's incomes at a low marginal tax rate while eliminating those exemptions, credits, deductions and loopholes which distort economic behavior and sap the economy's productivity.

The Need for Tax Reform:
Complexity

The tax code needs fundamental and complete reform. By now everyone agrees that the U.S. tax system is a national disgrace. It is blatantly inefficient, grossly unfair, and enormously complicated. There is little logic, reason, or economic theory behind the way the U.S. collects its taxes. With 40,000 pages, the current tax code is horribly complex and nearly impossible for the laymen to understand. The tangled web of regulations and red tape imposes significant economic costs and tends to undermine the equal treatment of taxpayers of similar circumstances. The paperwork is suffocating. Nearly 78% of federal reporting requirements arise from federal tax forms. And few can figure out how to fill out all that paper. Nearly 52% of all taxpayers are now driven to pay a professional tax preparer at a cost of $60 billion. Only 18% of all taxpayers had their taxes professionally prepared in 1954. The public spent 613 million hours in 1977 filling out some 260 different tax forms--about seven hours for each of the 90 million corporate and individual returns filed.

The snarled knot of complex provisions has generated an enormous upsurge in tax computation errors. 82% of all low income returns with itemized deductions contained errors, according to the IRS. The tax code has become so complex, in fact, that a 1975 IRS survey of its own trained employees showed that they computed the wrong tax 72% fo the time, even when handling realtively simple problems. One public interest research group sent out identical "test" tax returns to 22 different IRS offices and each office claculated a different tax liability, ranging from a high refund of $811.96 to a tax underpayment of $52.14.

Unfairness

Average taxpayers naturally feel disturbed and angry that our tax system permits such wide disparity in tax bills among taxpayers of similar circumstances. They feel that this enormous complexity is simply not necesary for fairness or efficiency. Honest taxpayer increasingly feel that they are "suckers" if they obey the laws. This sense of frustration and disgust undermines the system of voluntary compliance which is the basis of our income tax system. Although the IRS employees legions of agents, an army of agents could not suffice if the average taxpayer decides to resist paying taxes.

In spite of highly progressive tax rates, a crazy patchwork of tax shelters, loopholes, deductions, exemptions, and credits has rendered the tax code terribly unfair and inequitable. Responding to pressure from various special interests, Congress has increased the number of special preferences, including those relating to businesses, from 50 in 1947 to 104 in 1982. Working Americans, who can't afford the services of high-priced lawyers, accountants, and tax specialists, often feel that they are picking up the tab for cheaters, tax shelter promoters, and tax finaglers.

Since only the upper income taxpayer can take advantage of many tax concessions, the tax code has earned a reputation as being "soft on the rich." Working Americans resent that some of the "super rich" aren't paying taxes at all, while some of their colleagues, making the same salary, are paying a radically different tax bill to Uncle Sam simply because they have taken full advantage of the loopholes. The cruelest cut of all is that over $100 billion in taxes is never reported at all as a result of incomplete reporting, the underground economy, and outright cheating.

While perceived as too indulgent to the rich, the income tax is unfair to the poor. The most glaring injustice is that the poor pay taxes even though they are below the poverty line, or eligible for welfare. Two factors are responsible for this inequity: the decline in value of the personal exemption and tax bracket creep--both evils of inflation.

The personal exemption which shields the poor from high taxes has not kept pace with inflation or personal income. The personal exemption was $600 in 1948, today after decades of rising inflation, the personal exemption is only $1,000. If the 1948 figure were indexed for inflation, it would be over $2,500. If indexed for income growth, the personal exemption would equal $5,600 today. Treasury economist Eugene Steuerle writes that "By any measure the decline in personal exemption has been the largest change in the income tax in the postwar era."

Tax bracket creep, which is a far greater problem for the poor than for the rich who are already in the highest tax bracket, has also sharply increased taxes on lower income taxpayers. Even if the modest salaries of the poor kept up with inflation, they faced the steepest progressivity in the tax code of any tax groups. Due to these twin consequences of inflation, taxes more than doubled between 1965 and 1981 on those earning 50% of the median income level. Due to the delay of tax indexing, the poor continued to suffer somewhat higher average taxes between 1981 an 1984.

Disincentives

Perhaps most disgraceful are the tax barriers to the economic advancement of the most disadvantaged. Certain groups--most notably the poor, the aged, the unemployed--face government created "traps," which result from the interaction of government means tested programs and the incidence of the income tax. The following traps can impose marginal tax rates higher than even on the richest Americans:

--The poverty trap. With rising income, a poor family faces not only steeply progressive tax rates, but the cutoff of government benefits. A typical welfare family which takes an job, pays 27 cents in taxes on each additional dollar of income and loses an additional 35 cents in reduced welfare benefits, for a combined real marginal tax rate of 62%. In many cases, the effective marginal tax rate is much higher. Even though it earns more pretax income, the poor family could actually be worse off, or keep only a small fraction of it's extra income after income taxes.

--The unemployment trap. Unemployed people may sometimes be better off on unemployment compensation that working. Due to a similar combination of losing benefits and paying taxes, high marginal tax rates raise the cost of work relative to leisure, raising demoralizing barriers to those who would seek employment.

--The retirement trap. Retired workers between 65 and 70 lose an additional 50 cents in Social Security payments for every dollar of earned income above the government-imposed ceiling, now set at $6,960. Combining the loss of benefits with federal, state, and local taxes on earnings, the retiree who wants to work could face a 96% marginal tax bracket or more. The result: the elderly virtually are prohibited from working.

Apologists for the status quo claim that high marginal tax rates are necessary for a progressive and fair tax system. Marginal tax rates, however, say nothing about progressivity. We can have a progressive tax system with low marginal tax rates. And, we can have a regressive tax structure with high marginal tax rates. In fact, it is likely that the higher the marginal tax rate, the larger the number of rich who are driven to tax sheltering and the more regressive taxes become.

Our current high marginal tax rates, in fact, are mostly window dressing. Few people pay at the top marginal rate and little revenue is collected. Wealthy people instead escape to tax free bonds, tax shelters, tax evasion, or splurge on lightly-taxed luxury goods. As the rich flee from paying taxes, the working American who can neither afford nor have access to the inequitable provisions of the tax code is left paying a higher and higher tax burden. We can achieve the same progressivity of the current tax system without the inequalities, distortions, and complexity of high and rising tax rates.

Tax reforms who equate high marginal tax rates with equity just don't understand human nature or incentives. High marginal tax rates don't punish the already rich, they punish those striving to succeed: the up and coming entrepreneur or innovator, the hard-working small businessman, the investor risking his money on a new venture. Take away the fruits of their labors, and the labor itself will vanish--along with the spirit of enterprise and optimism.

High marginal tax rates have proved a counterproductive tool to promote a more equitable income distribution. Despite high progressive rates, the income distribution has changed very little in the post-war period. Indeed, between 1970-1979 when marginal taxes on most Americans soared, the income distribution shifted away from the lowest income groups. The cash income of the lowest percentile actually declined while the top 40% groups strenghened their position modestly.

Although high marginal tax rates have not redistributed income, they have twisted economic incentives and slowed economic growth. Everyone agrees that at some point marginal tax rates cause an enormous fiscal drag on the economy, demoralize taxpayers, and discourage productive activities.

The U.S. is still above this point judged by the fact that people plan every decision--from buying a car to purchasing a life insurance policy--with an eye to the tax consequences. Tax rates above 25% were once reserved to the rich. Now upwards of 30 million American taxpayers pay marginal tax rates of 25% or more. These high tax rates now apply to taxable income of more than $18,200 for an unmarried individual and $24,600 for joint returns--hardly what most consider rich. As long as most Americans pay rates of 20%-40%, there will be pressure for ever more loopholes, and the economy will hobble along at less than full potential.

Corporate Income Tax Inefficiency

The corporate income tax is even more in need of reform than the personal income tax. Most economists today agree that the corporate tax imposes an amazing array of distortions. The corporate profits tax, according to most public finance specialists : (1) distorts how companies total federal tax revenues, about 8.5% in 1984, or less than 1.6% of GNP. The contribution of corporate tax revenues, in fact, have fallen almost continuously over the post-war period. In 1964, for example, corporate taxes contributed 22.2% of federal revenue or 4% of GNP, more than double its current level. Under its malign impact, however, executives are making decisions which make little economic sense and do little to enhance economic growth, but which minimize their tax liability.

Kemp-Kasten: The Fair and Simple Tax Act of 1984--FAST.
(HR 5533, S 2600)

The case against the current corporate and personal income tax system is overwhelming and devastating. Few have ever come forward in its defense. The system fails and fails miserably on the traditional public finance criteria: equity, efficiency, and simplicity. It is a monstrous system which cries out for major overhaul. Piecemeal reform will only paint over a foundation which is cracked and flawed to its core.

We need a tax system which is simple, throwing away the thousands of pages of complex and unneeded rules, regulations, and redtape. A system in which taxpayers clearly know their obligations and can figure out their taxes without the help of fancy accountants and lawyers. We need a tax system which is fair. One which assures working taxpayers that all Americans will pay their fair share and not skip out of paying taxes by crawling through loopholes. Fairness means low marginal tax rates to bring the rich into the taxable economy and increase the progressivity of the tax code. We need a tax code which rewards enterprise, initiative, and thrift. Only if the tax code improves incentives for productive activities will the economy flourish, jobs be created, and poverty reduced.

Overview

The Kemp-Kasten bill incorporates these principles. It will not solve all the problems of the current tax code. But it certainly goes a long way. We are willing to make further modifications to the bill as necessary and prudent. Kemp-Kasten incorporates the following salient features:

1. FAST cuts the top marginal tax rate in half, dropping it down from 50% to 25%. After deducting generous personal allowances and a new employment income exclusion, all taxable income is taxed at the same 25% tax rate.

2. FAST helps poor people. FAST doubles the personal exemption for each taxpayer, spouse and dependent to $2,000, and increases the zero bracket amounts, or standard deductions. As a result of these generous allowances, Americans near or below the poverty level would no longer pay income tax under FAST. The income at which people start paying income tax would rise from $3,445 to $5,875 for a single taxpayer, and from $8,936 to $14,375 for a family of four. This lifts the income tax threshold above the poverty line. Inflation is the harshest on poor people because it pushes them into higher tax brackets. FAST indexes the tax code and thereby halts these unconscionable tax increases.

3. FAST is fair to middle income taxpayers. Many flat rate tax plans

choose to spend their capital, (2) biases corporate finance toward debt rather than equity financing, and (3) depresses the level of corporate investment.

While the 1981 depreciation changes were a giant improvement over the previous inadequate depreciation schedules, the current system imposes an irrational range of effective tax rates on corporate investment. Long-lived assets are taxed at incredibly high tax rates, while some short-lived assets are actually subsidized by the tax code. (see Table 1). Essentially, we are taxing structures to subsidize equipment. This results mostly from the interaction of the investment tax credit, which is applicable mostly to short lived equipment, and to the accelerated depreciation classes, which provide preferential treatment to short-lived assets.

This system has proved very unfair to less capital intensive companies, including the high tech industries which most observers regard as crucial to our economic leadership. Many of these industries are now taxed at very high tax rates, while other industries which can take advantage of the tax preferences pay sharply lower rates. In 1982, tax rates ranged from 4.1% for railroads and 15.6% for the utilities industry to much higher rates on the more "high tech" industries like computers and office equipment (26.4%) and instruments (21.9%).

The waste in the current system is tremendous: University of Virginia Professor, Don Fullerton, has estimated that the current corporate tax system costs the economty $50 billion a year by misdirectig capital investment. A more concrete measure of cost is the lagging investment in long-lived assets in the current recovery. While spending in equipment has set a record for any post-war recovery and is expected to rise another 14% in 1984, investment in structures and long-lived assets actually fell by 7% in 1983, and is expected to grow by a modest 3.8% in 1984. Yet investment in long term assets is crucial to modernizing and upgrading our capital structure.

The corporate tax structure also distorts the way corporations raise capital by making debt cheaper than equity finance. A $10 million interest expense is tax deductible, reducing the companies' tax bill by $4.6 million, at the current 46 percent statuatory rates. $10 million paid out for dividend expense, however, doesn't reduce the companies tax bill a penny. Clearly debt is favored.

There is an enormous anti-saving, anti-investment bias in our tax code. Corporate profits are now multiply taxed. Corporate profits are taxed when earned by the corporation at 46 percent, and then when distributed at rates up to to 50% if dividends, and 20% if capital gains. Then, corporate profits are taxed many more times: by property taxes, state and local corporate profits taxes, sales taxes, and many other smaller taxes. The combined corporate tax rate could reach over 70 percent. These high business tax rates severely depress the level of business investment.

For a tax which generates such an wide range of distortions, the corporate tax only accounts for a relatively small, and falling, share of raise average taxes on lower and middle income taxpayers. But FAST includes a new exclusion for employment income to protect wage and salary earners. The exclusion is generally 20% of employment income up to about $40,000, and is phased out entirely at about $100,000. This exclusion lowers the effective and marginal income tax rates and offsets the Social Security payroll tax, resulting in a smooth, almost flat total tax rate.

4. FAST simplifies the tax code. It broadens the tax base by eliminating most tax preferences or "loopholes." However, important deductions are retained for interest (including mortgages), charitable contributions, real property taxes and catastrophic medical expenses. Also retained are the current tax treatment of IRA's, Keoghs, Social Security and veterans' benefits.

5. FAST helps families. The tax code has penalized families and children because the dependent exemption has not kept up with inflation. FAST doubles the personal exemption (and indexes it to keep pace with inflation), increases (and indexes) the zero bracket amount, and provides a generous employment exclusion--all of which provides important protection for working families.

6. FAST indexes the tax code to protect everyone from future tax increases caused by inflation. For the first time, capital gians are indexed for inflation, to end the taxation of phony, inflated "gains" on assets like stocks or houses.

7. FAST improves the corporate tax code. Most tax preferences are repealed and the marginal tax rate is cut from 46% to 30%, with a reduced 15% rate for small businesses. The new depreciation schedules enacted in 1981 are retained, and the corporate capital gains tax is also reduced from 28% to 20%. And expensing for small business is also retained.

8. FAST raises roughly the same tax revenues as now, on a static basis. FAST also keeps about the same distribution of tax burden on various income groups as the current tax system. However, because many tax preferences are eliminated, most taxpayers whose deductions are no greater than average would receive a tax cut. For example, a family of four earning $20,000 which does not itemize deductions would receive a tax cut of $616.

Explanation of Advantages

FAST combines fairness with sound economic theory. And it is simple, eliminating most deductions and special provisions which have encrusted our tax system. For most taxpayers, their FAST tax return could fit on one piece of paper.

FAST is also fair. By eliminating many loopholes it assures that everyone will pay his fair share of taxes. It stops taxing those below the povery line. More than a million of the lowest income taxpayers are removed from the tax rolls.

FAST also helps millions more escape from the poverty, retirement, and unemployment "traps," caused by a combination of high tax rates and means-tested social welfare payments. FAST reduces high marginal tax rates on low income Americans and doubles the personal exemption. These provisions allow the retired, poor, and low-income unemployed to keep more of their earnings as they enter the work force. This restores incentive to seek work rather than rely totally on government benefits. FAST also restores equity for families by doubling the child deduction. No longer will families with children be penalized.

Undoubtedly, FAST's most important feature is its low marginal tax rates, which encourages upward mobility, thrift, and enterprise. FAST cuts today's top marginal tax rate in half, from 50% to 25%. This increases after-tax incentives by up to one-half. Taxpayers will no longer be rewarded for investing in boxcars, paper transactions, and tax scams. With marginal tax rates of 25%, most deductions won't be worth the cost. With tax rates up to 50%, every dollar of tax deduction is worth 50 cents. But if the tax rate were 25%, many tax shelters and deductions would not be profitable. Few would pay 30 or 40 cents on every dollar for a tax shelter, as many do, which only saved 25 cents in taxes.

A low marginal tax rate also lowers the cost of labor while increasing its reward. It minimizes the "tax wedge," which is the difference between a worker's after-tax wage and his cost to his firm. A worker considers his "reward" for working his after-tax wage, net of all deductions and taxes. He will work harder the greater his after-tax pay. An employer, however, is interested in the worker's cost to his firm, which includes payroll taxes, state and local taxes, and payroll deductions. The greater the gross wage of each additional worker, the fewer workers the firm can afford to hire.

An auto firm, for example, must give a typical worker $1.45 per hour to provide him a $1 raise after payroll and federal, state, and local income taxes. The 45 cent tax wedge, most economists believe, imposes a cost on the economy far in excess of the tax revenue raised. The tax wedge distorts the efficient level of work, savings, and investment, creating what economists call a deadweight loss or just plain waste. The tax wedge reduces the demand for workers--creating unemployment--and lowers the reward for working, both of which reduce the economy's potential output.

Taxes on interest income also drive a wedge between the after-tax return to saving, which is the "reward" or return that savers receive for foregoing consumption, and the real benefit of savings to society represented by the pre-tax interest rate. The tax wedge reduces the incentive to save, driving down the level of saving, and also increases the cost of funds, reducing investment.

In the FAST tax, average tax rates remain approximately what they are now. But marginal taxes are cut dramatically. This reduces the tax wedge on savings, investment, and work. It will encourage additional employment since the cost of labor is reduced, and will increase supply of workers since the reward for working is enhanced. It will generate more saving, by increasing the after-tax return, and will increase the demand for saving by increasing the rate of return on investment. Both the level and more neutral tax system which doesn't subsidize or target any industry, and minimizes interference in the free market.

FAST also improves the corporate tax system, and ameliorates distortions, in the following ways:

1. The reduction in the corporate rate from 46% to 30% helps small corporations which typically cannot use the capital cost recovery provisions as much as many larger businesses. Small family owned businesses which usually pay taxes through individual income tax schedules benefit from the reduction in the top individual income tax rate from 50% to 25%.

2. Kemp-Kasten reduces the bias favoring debt financing. At a 30% corporate rate, $1 of interest deduction reduces the corporate tax bill by 30 cents, while at the current 46% corporate tax rate, $1 interest expense is worth 46 cents in tax reduction. Kemp-Kasten reduces the relative advantage of debt over equity financing by 1/3.

3. FAST significantly reduces the double taxation of corporate income. The bill cuts the corporate profits tax (from 46% to 30%) and also the top marginal tax rate on dividends (from 50% to 25%) and capital gains (from 20% to 18.75). Under the current system, corporate capital could be taxed at combined tax rates up to 73%. Under Kemp-Kasten, corporate income will be taxed at combined rates up to only 48%, reducing the total tax rate on corporate capital by up to 1/3rd.

Conclusion

The current tax system requires radical reform. Piecemeal changes will neither solve the monstrous problems of the current system nor overcome the political challenges of the special interests which stand behind every tax break. Trying to change one provision or another in isolation will fail, thwarted by entrenched special interests. Tinkering will not simplify the tax code, restore simplicity and fairness, create jobs, or spur economic growth.

We need to change the tax system in one bold stroke. This will disarm special interests and gather broad public support. Even those who are hurt by one or another tax change will support a reform which promises a larger economic pie.

The Kemp-Kasten bill is economically and politically viable. It recognizes that the tax system is unfair, riddled with loopholes, and harsh on the poor. It also recognizes that high marginal tax rates damage economic growth. And it answers the worry of working taxpayers that flat taxes mean higher taxes. I hope that we can join with Members on both sides of the aisle, in a nonpartisan initiative, to give the American people a tax code which is fair and simple for everyone.

combination of labor and capital will be more efficient under FAST. The economy's potential output, employment rate, and efficiency all will be bolstered.

Evidence of Success

There is strong evidence, in fact, that high marginal tax rates cost taxpayers far more than they yield to the government. Shaving the top marginal tax rate to 25%, in fact, probably won't cost any tax revenue. IRS tax return data for 1982 show that when the top marginal tax rate was reduced from 70% down to 50%, tax revenues from the rich soared. Those making $1 million or more, for example, paid 41% more in tax revenues in 1982. Although tax rates on investment income were reduced by almost 30 percent for the top bracket taxpayers, tax revenues increased by 12.4% from those earning over $100,000. Those earning under $25,000, by comparison, paid 12% less tax revenues (see Table 2).

Not only did upper-income taxpayers contribute more taxes, but they also shouldered a bigger share of the overall income tax than before. The share of taxes paid by those making $40,000 or more increased from 45% to 48%, almost a 3 percentage point increase in their tax burden. The tax burden of those making $40,000 or less, by comparison, declined form 54.81% to 51.93%, a three percentage point decline. The substantial shift in the tax burden ot upper-income groups in the midst of one of the most sever business recessions on record is a powerful vindication of the incentive-enhancing effects of marginal tax rate reductions.

The evidence of the success of the previous tax rate reductions, not surprisingly, has met with a great outcry, proving the damage the IRS figures do to those believing that marginal tax rates don't affect incentives. But all the attacks cannot change the facts: tax revenues increased from upper-income taxpayers as tax rates were slashed.

Corporate Income Tax

Kemp-Kasten also brings some sanity into the corporate income tax. FAST rewards profit by taxing it at the lowest possible marginal tax rate. And it puts an end to many tax avoidance schemes, loophole exploiters, and paper shufflers.

FAST reduces the wide disparity in tax rates between investments and among industries. Current tax rates vary between negative 22% for investment in 3-year equipment (at 6% inflation) and over 36% for new investment in 15 year equipment (see Table 1). FAST eliminates the investment tax credit and lowers marginal tax rates to end the equipment tax subsidy and create a much more consistent range of tax rates for new investment.

FAST will also be more fair to labor intensive firms. These businesses were not able to use many of the 1981 capital cost recovery provisions and accordingly have faced much high effective tax rates. But why should firms which are innovative, growing, and profitable have to pay much higher tax rates than other industries? Under FAST, the top tax rate will be cut to 30%, creating a greater incentive for firms to invest in new projects, regardless of their labor-capital mix. FAST promotes a

TABLE 1

Theoretical Tax Rates on New Corporate Investment under Current Law

	Current Law Tax Rates	
	4% Inflation	6% Inflation
3-year equipment	-21.8%	-3.9%
5 year equipment	-13.6	-0.3
10 year equipment	15.5	22.0
15 year equipment	30.5	36.3
15 year structures	33.2	36.6
Weighted average	20.7%	28.4%

Table 2

Changes in Tax Revenues and Tax Burden by Adjusted Gross Income (AGI) (billions $)

All Returns ($ thousands)	1981 tax revenues	1982 tax revenues	% Change in taxes 1981-1982	1981 tax as a % total tax	1982 tax as a % of total tax
under 5	.7	.7	2.3	.25	.26
5- under 10	7.9	7.0	-11.8	2.72	2.46
10- under 15	17.7	15.7	-11.4	6.07	5.52
15- under 20	23.4	20.2	-13.6	8.03	7.12
20- under 25	27.9	24.7	-11.6	9.60	8.71
25- under 30	29.2	28.4	- 2.7	10.01	10.01
30- under 40	52.8	50.6	- 4.2	18.13	17.85
40- under 50	35.5	35.6	- 0.1	12.20	12.55
50- under 75	37.1	36.7	- 1.1	12.76	12.96
75- under 100	15.0	14.7	- 2.0	5.16	5.19
100- under 200	21.8	22.2	1.9	7.48	7.83
200- under 500	12.8	14.3	11.8	4.41	5.06
500- under 1000	4.1	5.6	35.6	1.42	1.97
1000 or more	4.9	6.9	41.2	1.69	2.44
Total	291.1	283.5	- 2.6	100.00	100.00

Representative **Hamilton**. Congressman Kemp, we appreciate your effective presentation of your bill. It's a very great pleasure to have you with us for this discussion.

Representative **Kemp**. Thank you.

Representative **Hamilton**. You ended up with a comment about politics, and I'll begin there. Let's talk a moment about how you size up the prospects of getting radical change in the Tax Code.

We have been in the Congress for a while. We both recognize that tax changes come very hard and that even when you have major changes in the Tax Code, they tend to be more incremental than they are radical.

Representative **Kemp**. Yes.

Representative **Hamilton**. And I think it's fair to say your bill would be a radical change in the Income Tax Code, without any doubt. It is a radical change.

When you move a comma, when you move a word, in the Internal Revenue Code, we get a flood of lobbyists, and it is very, very tough to do.

Now, are you optimistic that the country is in a position where we can take a radical change in the Income Tax Code, given your understanding of the difficulties of achieving any change in the code?

Representative **Kemp**. It's a good question, Mr. Chairman, and I think it's an orthodox one. I know that's not necessarily your position, but it's a very conventional view in this town. And there are so many lobbyists stringing through the Halls of Congress that we will never be able to do anything radical, as you use the word. Incidentally, "radical" is not necessarily a bad word. "Radical" in Latin means to go back to roots.

Representative **Hamilton**. I didn't mean it in that sense. It's a major change.

Representative **Kemp**. That's right. I know you didn't mean in a social revolutionary sense, but in the sense that "radical" in the dictionary means to get back to roots, to get back to premises, to get back to basic foundation blocks. And the basic foundation block of the tax system is never discourage the industriousness of a people. And I think this tax system not only discourages industriousness and entrepreneurship and working and producing; I think it to a large degree obfuscates, confuses, exasperates, and actually is causing some of the cheating.

Now, there are two ways to look at our tax system. You can either say, "We ought to hire more IRS agents" and go out and dig into people's bank accounts and their savings accounts and the underground economy and put black and brown arm bands on IRS agents, which I frankly think is a very elitist view of our underground economy. I'm not saying there aren't cheaters. They ought to be caught or prosecuted. Mr. Chairman, when you see a large underground economy, as you do in the United States of America, as you do in Israel—Israel's underground economy as a percent of economy is bigger than ours, as is the United Kingdom. You've got to look somewhere beyond just tax collection.

And I think the problem is that the system is corrupted—I don't mean on purpose, but it's been corrupted by all those special interests, and the way is to leap over them, take it to the American people. I guess that's my bottom line. Let's make the debate 1984 one of tax reform. Let's ask the American people, "Do you want to liberate America's economy from shelters and loopholes and special interests and bring it back into building a bigger pie, a bigger industrial base, and making this country more effective in world markets?" as I think this would help do. Or, "Do you want to continue as is? And if you want to continue as is"—it depends on who is for the status quo.

Representative **Hamilton.** Do you think the country is ready for this kind of change?

Representative **Kemp.** I think the American people would resoundingly say "Yes." I mean, my bill should be changed in certain aspects, and I think Bradley-Gephardt are starting to reconsider some aspects of theirs. But if Ronald Reagan campaigns on something like Kemp-Kasten—and I plan, as Bob does, to get it into the Republican platform and make it a part of our party's pledge to the American people in 1984—and if Bradley-Gephardt finds its way into the Democratic platform, as I hope it does, I think we are going to have a resounding debate in 1984 to the benefit of the American people.

Representative **Hamilton.** What kind of reaction have you had to your bill from the administration?

Representative **Kemp.** Well, the President has said many times, particularly recently, that he would like to simplify; he would like obviously fairness; he would like to lower the rates. He said, to clear up a misunderstanding before the home builders in Houston several months ago that he wants to retain the deduction on the interest on a mortgage, which, I must admit, I was glad to hear him clarify.

Representative **Hamilton.** He's coming your way?

Representative **Kemp.** Well, I think intuitively he was already there, but it's nice to see that the party is beginning to think this way. We have a lot of cosponsors.

Representative **Hamilton.** They have not accepted it?

Representative **Kemp.** Your party hasn't accepted Bradley-Gephardt, either.

Representative **Hamilton.** I understand. They have not accepted your bill, but you think they are looking at it seriously. Do you think that would be fair to say?

Representative **Kemp.** It's going to be in the platform or awfully close to it. We are not going to dot the final "i," Mr. Chairman, and probably the Democratic platform won't either. And there is some problem with this debate, because Mr. Hart and Mr. Jackson and Mr. Mondale all want to get the deficit down by putting surtaxes on income above some X level of income. Jesse Jackson wants it above $25,000 and Gary Hart wants it above $50,000 or $60,000, and Mondale wants to wait until you earn $100,000 before you have to face that 10-percent surtax. But that, too, should be debated. Surtaxes raise income or lose income. I could make a case that they lose income for the IRS.

Representative **Hamilton.** One of the things that is striking about Bradley-Gephardt and your proposal and the proposal of Senator Kasten is that there are an awful lot of similarities.

Representative **Kemp.** Yes.

Representative **Hamilton.** You've pointed out some of the differences, and I don't want to understate those differences. They are important. But there are a lot of similarities, and that leads naturally to the question: Has there been any consideration at all between you of trying to meld the two, or aren't you at that point yet?

Representative KEMP. I had talked to Bill Bradley. He and I appeared before the National Association of Home Builders Economic Task Force several weeks ago, and we have crossed paths with each other in New York and here in Washington and throughout our speaking schedules. And I was up in New Jersey recently and he was talking about it. And I haven't recently talked to Gephardt but I know he's a man of compromise, a man of good will. So I think the possibility is there.

Maybe I'm speaking on both sides of the issue when I say I want it to be part of a political issue in 1984, and at the same time we should be getting together with Bradley and Gephardt, but I think both are possible. I think the American people are telling us, "Hey, Hamilton and Kemp and Kasten and Gephardt and Bradley, get together and get this thing ironed out to the good of the American people on a bipartisan basis." I know you'd be willing, and I would, too.

Unfortunately, we have lots of folks who disagree with us, Mr. Chairman. As you know, the major candidates of your party are kind of going the other way right now, and it may have to be decided by the American people. But would I go to Bradley and Gephardt and say, "Let's work this out"? The answer is "Yes."

Representative HAMILTON. Let me bring up some criticisms of your proposal that were voiced yesterday in our hearing by a couple of our witnesses.

One relates to the distribution of the tax burden in your bill. They found it distributionally neutral up to an income level of about $100,000, but above that income level it would reduce the tax burden and actually lose revenues.

I don't put forward that criticism to you as one that is absolutely valid; I don't know whether it is or not. But I would like you to address it. If you can't do it now, I'd like for you to address it at some later point.

I guess the question is: Can you give us figures that would compare the tax burden by income level under your bill with current law? That's really my request here.

Representative KEMP. Well, we faced that issue, you and I, in the last Congress. And, of course, we must realize, as I know you do, Mr. Chairman, being a keen observer of the economy, that those estimates are based upon a static analysis. I mean if no one did anything and they sat on their yacht in New York Harbor and someone came up and said, "We're going to cut your tax rate from 70 to 30 percent," and you still invested in tax-free municipal bonds, then on that static basis, if there is no change in the investment savings climate of this country, Mr. Chairman, you're right—you lose revenue.

Now, the question is: Does that fit our understanding of what people do? Do rewards work? Do incentives work? Do changes in marginal tax and cost rates change people's behavior? And I want to suggest that as the evidence comes in from 1981, the way to tax the rich is not to raise their rates. The way to tax the rich is to get the rates set at a point at which it is marginally unproductive to put it into a tax-free municipal bond or a shelter or a loophole.

Let me just put a footnote on this because it's a vital one. The evidence is in from 1981 clearly—I'm not saying it's over, and evidence is continuing to pile up—but so far, Mr. Chairman, the wealthy today are paying higher taxes at the lower rates under Ronald Reagan than they were paying into the income tax coffers when the rates were higher under the previous two, three, four administrations. The drop in the 70-percent bracket to 50, the lower rates across the board, have tended to shift decisions away—tended, not totally, but tended to begin the process of liberating some of that shelter and some of that loophole and putting it into more productive use, not only for the individual but also ultimately for the good of this economy.

I think the way to tax the rich is to get the rates set at a point where it is absolutely impossible to spend all your time hiring lawyers and accountants and finding ways of hiding sources of taxable income. The way to do that, I think, is to set the rate at a lower level. That's where Bradley and Gephardt have come out, and that's where Kemp and Kasten have come out, and I think that's where the President is coming down on. We will get more revenue with lower rates than we will by raising the rates or putting on surtaxes.

I don't know if you've had the testimony of the professor from Florida State who testified yesterday before the Joint Economic Committee. But I think he made the point that every 1-percent increase in the marginal income tax rate above a certain level of income or a certain bracket diminishes the amount of revenue that comes into the Treasury from that bracket of taxation.

I asked a question on CSPAN—it wasn't CSPAN; it was CUBE, the communications network broadcast in Columbus, OH, and Cincinnati—when Warner Brothers asked Tim Wirth and me to come on—you know, they have the instant computer that calculates on your television set what the results of a poll were, and we were just doing it by wildcatting a little bit. But I asked people in Columbus and Cincinnati—40,000 homes or 20,000 homes or whatever it was—if they thought anybody should pay 70 cents tax on a dollar of income, you know, "Do you really think anybody should pay 70 cents on a dollar of income?" This was before Kemp-Roth. I think 86 percent of the people, who answered simultaneously almost, within 50 seconds of the question, said, "No."

I don't think people really want to tear down the rich. They want a chance to get rich. The point I'm making is, we don't need a tax system that redistributes income and makes everybody look for shelters or tax lawyers. We need a tax system that allows the poor to get rich and accumulate some income and be able to do for themselves what can be done in a private enterprise system.

Representative Hamilton. You've spent a lot of time on this and I've got a lot of questions. I'm not going to be able to ask them all because I don't want to take up a lot of your time. But let me raise just a couple of other things about your bill that I'm interested in.

One is that you maintain the ACRS appreciation system.

Representative Kemp. Yes, sir.

Representative Hamilton. There is some evidence, at least, that the ACRS system generates overinvestment in some kinds of capital and underinvestment in other kinds. The question really is: Why do you choose to maintain that kind of depreciation system when other alternatives might be more neutral?

Representative **Kemp**. Well, the choice was, Mr. Chairman, in order to keep some basic conditions of paramount importance politically, that is, revenue neutrality, keep the distribution of the burden relatively the same—which I think it will, Mr. Chairman—raise revenue, lower the underground economy, and keep capital formation rising ~~both~~ from personal and corporate income sources. We didn't totally eliminate the double taxation of dividends, which I favor; we didn't go to expensing, which I ultimately favor and which was in the Democratic Party's caucus position in the 1981 tax debate when Danny Rostenkowski, chairman of the Ways and Means Committee, wanted to go to expensing within 3 to 5 years. I favor that as well, Mr. Chairman.

But we didn't want to do what the Bradley-Gephardt bill did, and that was go back to pre-1981 depreciation schedules. So we just kept it according to the 1981 accelerated depreciation rates on the premise that this was not an area in which we had the greatest concern. We didn't want to lose revenue. We didn't necessarily want to do everything—maybe I'm arguing against my so-called radical new tax reform, but I didn't want to lose a debate over a revenue figure. And I knew that with the deficit ranging somewhere between $100 and $300 billion—Stockman says it's $300 billion, Henry Kaufman says it's infinity, whereas I think the deficits are bad that are going down and at the Federal, State, and local level are far better than Kaufman, Volcker, CBO, OMB will tell us—I just didn't want to get in a debate over deficits in 1984 like we did in 1981, so we kept the revenue neutral. And for other reasons, we just stayed away from changing toward a more accelerated depreciation schedule. We will leave that debate for the future.

Representative **Hamilton**. You also have in your bill unlimited capital loss offsets.

Representative **Kemp**. Yes.

Representative **Hamilton**. The current law has a limitation on that of several thousand dollars—I think it's three. Isn't the unlimited capital loss offset provision going to invite selling off depreciating assets to offset other income and provide for the opportunity for manipulation of income?

Representative **Kemp**. Mr. Chairman, I think you probably could go through the tax bill, as we envision it, and even Bradley-Gephardt, and find—I hope it doesn't sound as defensive as it may at the beginning—some avenue by which some greedy person might take advantage of the Tax Code. I'm sure you'll find that under any form of taxation.

I think you also have to recognize, however, which offsets that point, Mr. Chairman, that if you want to restore to this country the type of an entrepreneur climate where people are willing to take big risks to go into business or to start a business or to wildcat a new technology, you are going to have to recognize that the ability to write off that loss will preserve in the main a better climate for entrepreneurship, recognizing that ultimately the only way to create employees is to create lots of new employers. We need to create lots of new employers.

Women are going into business as never before. Blacks are going into business as never before. We need more of it. Business starts in 1983 and 1984 are up by almost 40 percent over 1982. Of course, that's not hard because 1982 was a terrible year. But they are up over the 1970's. Frankly, we are creating more jobs in this country in 1 year than Europe has created in 10 years. And I don't want to do anything, Mr. Chairman, that might impede the ability of the entrepreneur employer to establish a lot of new jobs. I believe in full employment without inflation, and I think we should not penalize people for losing money in some venture in which they are out trying to create something new that ultimately might create a job and, second, might create a new product or service or technology to the American people. I think it would be a little bit unfair.

Representative HAMILTON. You have a marginal tax rate of 25 percent for individuals, 30 percent for corporations.

Representative KEMP. Right.

Representative HAMILTON. Would you envision any additional incentives to stimulate saving and investment, or do you think that that in itself will do it?

Representative KEMP. Well, the combination of the corporate tax code, which would be favorable to retaining earnings and building up the cash flow of both small and medium or, third, larger business—savings are not just the per capita savings rate against personal income. Savings rates have to be measured by other statistics: Retained earnings, corporate profits, personal income, et cetera. So we retain IRA accounts, Keogh accounts; we lower the tax rates by a significant amount; we lower the rates across the board, and we change the corporate tax laws. I think savings would rise.

But Mr. Chairman, in the final analysis, savings are going to be predicated upon the long-term projections or long-term predictability of the value of a dollar. And if our monetary policy is aimed at inflating the dollar, then savings are going to drop, irrespective of what you do to the tax cut.

So I guess I bring it up again as a broken record. I think monetary policy right now is critical to the future of this country's ability to inject the necessary oxygen into this economy to keep the recovery going, to bring down interest rates, make the dollar more competitive.

Representative HAMILTON. Let me ask you one final question.

Representative KEMP. We ought to hold hearings on him, why he won't tell us what he's doing.

Representative HAMILTON. I'm for that.

Let me ask you one final question on Bradley-Gephardt. As you look at Bradley-Gephardt and your own bill, what is it in your bill that you think is most important among the differences? Is it the indexation? Is it the retention of capital gains? Is it the depreciation schedule?

Representative KEMP. All of the above.

Representative HAMILTON. I'm trying to get some idea of your sense of the priorities.

Representative KEMP. The priorities are this: We have a lower personal income tax rate, but theirs is lower and that's very healthy. About 25 percent—history tells us above that people begin to look for tax consequences as opposed to economic consequences, but I'd be happy with 30 percent. I'd like to go to 25 percent but I'd be happy with 30 percent.

Second, they raise the capital gains tax. This is no time to be raising the capital gains tax. We have had tremendous benefits from lowering the capital gains rate on venture capital and equity capital in the United States.

For joint returns with incomes above $50,000, average tax rates go up quite substantially under Bradley-Gephardt. This is largely a result of the higher tax on capital gains and a discriminatory limit on tax exemption and deductions for incomes above the 14-percent base rate.

Incidentally, Mr. Chairman, take the interest on the mortgage. On the Bradley-Gephardt you can only write off your interest on the first bracket, 14 percent. You can't write it off against the 30 percent bracket. So, in effect, you do not get a total ability to write off the interest on your mortgage under Bradley-Gephardt.

Let me just finish. They have higher rates on personal income, higher capital gains rate, they take out indexing, they go back to the pre-1981 depreciation schedules, and they don't allow the full writeoff from some of those deductions that all of us consider important.

For that purpose, I'd like to ask unanimous consent to put in a comparison of Kemp-Kasten with Bradley-Gephardt, done by Alan Reynolds, former economist at City Bank of Chicago or First National Bank of Chicago, and now of Polyconomics in Morristown, NJ. I'd like to put this in the record.

And thank you, Mr. Chairman.

Representative HAMILTON. Yes, indeed. We are delighted to have had you.

Representative KEMP. It's a pleasure. I look forward to working with you, Mr. Chairman.

[The document referred to follows:]

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KEMP-KASTEN: A VIABLE FLAT TAX

By Alan Reynolds

The new Kemp-Kasten tax bill reduces and equalizes marginal tax rates at 25-30%, while doubling exemptions and preserving major deductions for all taxpayers. Indexing of capital gains, with full deduction of losses, would lift a big risk from long-term investment.

Bradley-Gephardt (the only serious rival) greatly increases average tax rates on higher incomes and threatens to inflate the middle class into surcharge brackets where exemptions and deductions are disallowed. Personal and business investment would be discouraged by repealing indexing and accelerated depreciation, severely restricting deductions for interest expense and raising the tax rate on capital gains.

May 21, 1984

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KEMP-KASTEN: A VIABLE FLAT TAX

Introduction of the Kemp-Kasten "fair and simple tax" (FAST) greatly increases the political odds of beating-back higher tax rates with a fundamental tax reform. Although there are many tax proposals floating around, the real contest is between Kemp-Kasten (S.2600) and Bradley-Gephardt (S.1421). Bradley-Gephardt was co-sponsored by Senators Hart and Kennedy and carries rhetorical support from Mondale. Kemp-Kasten has over two dozen influential co-sponsors, including House minority whip Trent Lott. The Treasury Department is not likely to push for a significantly different proposal, such as a value-added or other consumption tax, and it would not change congressional preferences if they did.

The U.S. tax system has drifted increasingly from accepted standards of maximizing incentives, neutrality, simplicity and fairness. There was some improvement in 1983 and 1984, as a result of 1981 legislation, but considerable damage remains unrepaired.

A family of four with double the median income saw *average* federal tax rates rise from 12% in 1965 to 19% in 1981, but *marginal* tax rates rose from 22% to 43%.[1] Clearly, that increased disincentive to add to earnings was way out of proportion to the relatively small increase in average tax rates. When all taxes and transfers are considered, estimated marginal tax rates are about 54% for the poorest fifth of Americans, 45% for the most affluent.[2]

Both the Kemp-Kasten bill and Bradley-Gephardt propose to reduce marginal tax rates for individuals and corporations by eliminating many deductions, credits and exclusions. Despite superficial similarities, however, Kemp-Kasten is a surprisingly dramatic improvement over Bradley-Gephardt.

Table 1 estimates individual tax rates for hypothetical taxpayers, with marginal rates in parentheses. These tax rates are summarized from detailed examples provided by Senator Bradley, except that the estimated value of mortgage interest deductions is somewhat larger and more realistic.

For joint returns with incomes above $50,000, average tax rates go up quite substantially under Bradley-Gephardt.[3] This is largely a result of a higher tax rate on capital gains and a discriminatory limit on tax exemptions and deductions for incomes above the 14% base rate. A tax surcharge of 12% on joint incomes above $40,000, 16% above $65,000, is applied to expanded gross income, not to taxable income after deductions. The mortgage interest deduction, for example, is not allowed in calculating tax rates above the 14% bracket, though there is no such limit under Kemp-Kasten.[4]

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[1] Congressional Budget Office, *Reducing the Deficit* (Feb. 1984) p. 188.

[2] E.K. Browning and W.R. Johnson, "The Trade-Off Between Equality and Efficiency" *Journal of Political Economy* (April 1984).

[3] Under less-favorable examples than Senator Bradley provides, taxes on incomes of $166-280,000 could rise by 50-300%. Arthur Andersen & Co., "The Flat Rate Tax" *Washington Tax Letter* (Aug. 6, 1982).

[4] As TRB writes in *The New Republic* (May 28), "Mondale himself...is on record in support of a severe cutback in the home mortgage interest deduction."

Table 1
ILLUSTRATIVE AVERAGE AND MARGINAL TAX RATES

								Max. Capital Gains Tax	Max. Corp. Tax
Salary	$15.000	30.000	30.000*	60.000	60.000	60.000	200.000		
Capital Gain	–	–	–	–	40.000	–	400.000		
Interest & Dividends	–	–	–	200	20.000	60.000	400,000		
Tax Rates Avg. (Marginal):									
1984 Law	6 (14)	13 (25)	9 (22)	12 (33)	13 (38)	18 (42)	17 (50)	20	46%
Bradley-Gephardt	6 (14)	10 (14)	9 (14)	13 (26)	21 (30)	20 (30)	25 (30)	30	30
Kemp-Kasten	1 (20)	10 (20)	8 (20)	11 (20)	14 (28)	15 (28)	18 (25)	19	30

*with large itemized deductions under current law.

Source: Adapted from detailed examples for married taxpayers prepared by the office of Rep. Jack Kemp. Average tax rates based on gross income (sum of the first three rows).

Employer-paid health and life insurance are added to adjusted gross income under Bradley-Gephardt, which also increases Social Security taxes.

Although marginal tax rates are of primary importance for added output, Bradley-Gephardt's increase in average rates at higher incomes is so steep as to threaten a loss of existing output, if not a revolt of managers and professionals. The disguised egalitarian nature of the bill is one reason why it is unlikely to be enacted, even by a Democratic president.

Kemp-Kasten and Bradley-Gephardt retain deductions for IRAs, charitable contributions and major medical expenses (though such deductions are limited to 14% under Bradley-Gephardt). Kemp-Kasten allows full deduction for interest expenses, since costs are not income. Bradley-Gephardt allows a 14% deduction for mortgage costs on a principal residence and *for other interest expenses only up to the amount of investment income.* Borrowing in one year to realize a capital gain in the next would result in taxation of the gain at income tax rates but no deduction for the interest expense.

Bradley-Gephardt repeals tax indexing so the tax surcharges would apply to lower and lower real incomes over time. *Capital gains are subjected to the surtax rate of 26-30%* with no exclusion or inflation-adjustment and limited deduction of capital losses.

Kemp-Kasten, by contrast, extends indexing to capital gains or, during a 10-year transition, allows the option of a 25% exclusion from the 25% rate (e.g., an 18.75 rate). There is also *full deduction of capital losses.* The zero-bracket level of income would be indexed, as well as the threshold for calculating an "earned income exclusion." "Bracket creep" becomes impossible because of the single 25% tax rate on taxable income. Bradley-Gephardt's surtax approach invites egalitarian increases, while the single-rate of Kemp-Kasten could be raised only with broad electoral support.

Bradley-Gephardt raises the personal exemption to $1,600-1,800, but leaves it at $1,000 for children and most spouses. Moreover, the surtaxes are calculated on expanded gross income, regardless of exemptions. Bradley-Gephardt imposes a much larger tax at very low incomes than Kemp-Kasten.

Kemp-Kasten doubles the exemptions to $2,000 for every adult and child, which should increase birth rates. There is an "earned income exemption" which merges the income and Social Security taxes in a particularly clever, equitable and efficient way. The Social Security tax is a flat rate levy that *excludes* investment income and drops to a zero marginal rate above the maximum FICA wage base (which is now indexed). Kemp-Kasten excludes 20% of wage and salary income up to the Social Security wage threshold (about $40,000 in 1985) with the exclusion gradually phased-out around $100,000. Together, the two taxes create a smooth, relatively flat marginal rate, without sharp discontinuities. Neutrality between labor and investment incomes would be improved, since only "earned" income is taxed by Social Security and therefore partly excluded by Kemp-Kasten.

At the corporate level, the *average* tax rate was reduced from 47% of inflation-adjusted profits in 1980 to 33% in 1983.[5] But the marginal rate remains high, uneven and vulnerable to inflation. New structures do not benefit from the investment tax credit, and thus face a 36% marginal rate.[6] Investments with a 10-year depreciation would pay a 22% tax at 2% inflation, but 44% at 10% inflation.[7] Non-depreciable investments, or added profits from managerial efficiencies, pay a marginal rate of 46%.

A simple way to reduce these distortions, and produce greater uniformity of corporate tax rates, is to lower the rate and eliminate some credits and deductions. Both Bradley-Gephardt and Kemp-Kasten share this conceptual approach, with a 30% corporate rate, but there are vast differences in the effective tax rates. Kemp-Kasten retains accelerated depreciation, with a 3-15 year write-off. *Bradley-Gephardt extends depreciation to 4-40 years,* with real estate and petroleum storage facilities placed in the 40-year category. Under Kemp-Kasten the first $50,000 of corporate income is taxed at a 15% rate.

Bradley-Gephardt eliminates constructive tax breaks for citizens living abroad, the enterprise zone provisions for Puerto Rico and possessions (already weakened by TEFRA), and depletion allowances and intangible drilling costs for domestic oil and gas exploration. Oil and gas wells would face 10-year depreciation under Bradley-Gephardt, rather than Kemp-Kasten's 3-year write-off.

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[5] *Economic Report of the President* 1984, Table B-82.

[6] Charles R. Hulten, "Tax Policy and the Investment Decision" *American Economic Review* (May 1984) p. 238.

[7] Charles E. McLure, Jr. "Corporate Income Tax: Restoration, Integration or Elimination?" in J.H. Moore (ed.) *To Promote Prosperity* (Hoover Inst. 1984) pp. 313-14.

Table 2 lists average 1982 tax rates for many industries. To the extent that 1982 results were fairly typical, there is some rough indication about which industries might gain or lose from a lower tax rate with fewer deductions. On average, effective rates under Kemp-Kasten should cluster around 20-25%, with the biggest beneficiaries of accelerated depreciation (construction and industrial equipment, trucks and buses) continuing to face *relatively* low rates. Oil and gas extraction paid above-average corporate tax rates of 32% in 1982, 40% in 1971-81, despite depletion allowances and intangible drilling expenses; such tax rates would be generally lower under Kemp-Kasten, making it easier to compete for capital.

Neither Kemp-Kasten nor Bradley-Gephardt is explicitly aimed at increasing short-term revenues, which would lessen chances of enactment. Yet a tax system that does the least possible damage to incentives, and minimizes distortions in the efficient use of resources, will also yield more taxable income over time. Since many of the deductions and credits eliminated by these bills have been growing more rapidly than incomes, that factor too would tend to preserve the tax base.

The general idea of a broad-based tax with low rates is attracting political entrepreneurs in both parties because it is attractive to voters, not just to economists. A recent poll by Market Opinion Research finds 54% in favor of a flat tax, 35% opposed. When Kemp-Kasten is described, 64% favor the bill with only 26% opposed. With that kind of voter appeal, the chances of a supply-side tax reform becoming a major election issue should not be prematurely dismissed.

Table 2
EFFECTIVE TAX RATES BY INDUSTRY, 1982

Finance, Insurance and Real Estate	37.3%
Metal Mining	34.3
Petroleum and Coal Products	33.2
Crude Petroleum and Natural Gas Extraction	32.2
Transportation Equipment, except Motor Vehicles	30.4
Furniture and Fixtures	28.6
Printing, Publishing and Allied Industries	28.1
Retail Trade	27.5
Primary Metal	26.0
Radio Broadcasting and Television	25.8
Lumber and Wood products	25.3
Machinery	24.6
Stone, Clay and Glass Products	24.6
Tobacco Manufacturers	24.3
Services	23.9
Textile Mill Products	22.8
Railroads and Railway Express	21.4
Chemicals and Allied Products	20.1
Gas Utilities	20.0
Rubber and Miscellaneous Plastic Products	19.8
Telephone, Telegraph & Miscellaneous Communications	19.7
Wholesale Trade	18.7
Paper and Allied Products	18.3
Agricultural Production	16.8
Nonmetallic Mining and Quarrying, except Fuel	15.6
Trucking Service, Warehousing and Storage	14.7
Construction	13.1
Air Transportation	11.5
Street Railway, Bus Lines and Taxicab	10.0
Water Transportation	6.3

Source: Alan Auerbach, "Corporate Taxation" *Brookings Papers on Economic Activity* 1983 II.

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MAJOR TAX REFORM PROPOSALS

Item	Kemp-Kasten "FAST"	Bradley-Gephardt "Fair"	Present Law "Present"
	INDIVIDUAL INCOME TAX		
Indexing Retained	Yes	No	Yes
	Marginal Tax Brackets Single Persons		
$000-2300	0%	0%	0%
2300-2600	0	0	11
2600-3000	20	0	11
3000-3400	20	14	11
3400-4100	20	14	12
4100-4400	20	14	12
4400-6000	20	14	14
6000-6500	20	14	14
6500-8500	20	14	15
8500-10,800	20	14	16
10,800-12,900	20	14	18
12,900-15,000	20	14	20
15,000-16,000	20	14	23
16,000-20,000	20	14	23
20,000-23,500	20	14	26
23,500-25,000	20	14	30
25,000-28,800	20	26	30
28,800-30,000	20	25	30
30,000-34,100	20	26	34
34,100-37,500	20	26	38
37,500-39,300	20	30	38
39,300-40,000	28	30	38
40,000-41,500	28	30	38
41,500-55,300	28	30	42
55,300-81,800	28	30	48
81,800-102,180	28	30	50
102,180 and above	25	30	50
	Married Persons		
$0-3400	0%	0%	0%
3400-3500	0	0	11
3500-5500	20	0	11
5500-6000	20	0	12
6000-6700	20	14	12
6700-7600	20	14	12
7600-10,000	20	14	14
10,000-11,900	20	14	14
11,900-16,000	20	14	16
16,000-20,200	20	14	18
20,200-24,000	20	14	18
24,000-24,600	20	14	22
24,600-26,000	20	14	25
26,000-29,900	20	14	25
29,900-35,200	20	14	28
35,200-40,000	20	14	33
40,000-45,000	20	26	33

45,000-45,800	20	26	33
45,800-58,950	28	26	38
58,950-60,000	28	26	38
60,000-65,000	28	26	42
65,000-85,600	28	30	42
85,600-109,400	28	30	45
109,400-153,270	28	30	49
153,270-162,400	25	30	49
162,400 and above	25	30	50

EXEMPTIONS

Self,Spouse	2000	1500(.14)	1000
Dependents	2000	1000(.14)	1000
Elderly	No Extra	1000(.14)	1000
Blind	No Extra	1000(.14)	1000

PERSONAL DEDUCTIONS

Mortgage Interest	Yes	Yes(.14)	Yes
Other Personal Interest	Yes	No	Yes
Property Taxes	Yes	Yes(.14)	Yes
Income Taxes	No	Yes(.14)	Yes
Other Local Taxes	No	No	Yes
Charitable Contributions	Yes	Yes(.14)	Yes
Medical Expenses	Yes(10%AGI)	Yes(10%AGI,.14)	Yes(5%AGI)
Two Earner Deduction	Repealed	Repealed	Yes(10% lower salary)

OTHER INDIVIDUAL

Income Averaging	Repealed	Repealed	Yes

RETIREMENT

IRA Earnings	Deferred Tax	Deferred Tax	Deferred Tax
IRA Deductions	Yes	Yes	Yes
Keogh Earnings	Deferred Tax	Deferred Tax	Deferred Tax
Keogh Contributions	Yes	Yes	Yes
Corporate Pensions	Deferred Tax	Limited	Deferred Tax
Social Security	Excluded	Excluded	Excluded

INVESTMENTS

Maximum Capital Gains Rate	19%,then 25%	30%	20%
Capital Gains Exclusion	25%, then 0%	0%	60%
Capital Basis	Indexed	Not Indexed	Not Indexed
Dividend Exclusion	$0	$0	$100/200
Homeowner Exclusion	Yes	Partial	Yes
General Obligation Municipal Bonds	Not Taxed	Not Taxed	Not Taxed
Other Municipal Bonds	Taxed	Taxed	Not Taxed
Alternative Minimum Tax	Retained	Repealed	Yes

DEPRECIATION

Investment Credit	None	None	6-10%
Depreciation Method	ACRS	Modified ADR	ACRS

Asset Life

ADR Midpoint Life			
0-5.0	3	4	3
5.5-8.5	5	6	5
9.0-14.5	5	10	5
15-24	10	18	10
25-35	15	28	15
35 and over	15	40	15
Declining Balance Percentage	NA	250%	NA

LOWER INCOME

Earned Income Credit	Yes,Modified	Retained	Yes
Child Care Credit	Repealed	Ded.(.14)	Yes
Unemployment Compensation	Taxed	Taxed	Taxed over $12,000
Worker's Compensation	Not Taxed	Not Taxed	Not Taxed

EMPLOYER PROVIDED FRINGE BENEFITS

Health Insurance	Benefits Taxed	Included	Excluded
Life Insurance	Excluded	Included	Excluded
Other Statutory	Included	Included	Included

MAJOR TAX REFORM PROPOSALS

Item	Kemp-Kasten "FAST"	Bradley-Gephardt "Fair"	Present Law "Present"
CORPORATE INCOME TAX			
Basic Rate	30%	30%	46%
Capital Gains Rate	20%	30%	28%
Reduced rates, first $100,000	15% to $50,000	Repealed	Retained
DEPRECIATION			
Depreciation	ACRS	Modified ADR	ACRS
Investment Tax Credit	None	None	6-10%
NATURAL RESOURCES			
Percentage Depletion	Repealed	Repealed	Yes
Expensing Exploration, Development Costs	Repealed	Repealed	Yes
Intangible Drilling Costs	Repealed	Repealed	Yes
Capital Gains Coal Royalties	Repealed	Repealed	Yes
Alternative Fuel Credit	Repealed	Repealed	Yes
Alcohol Fuel Credit	Repealed	Repealed	Yes
Energy Conservation Credit	Repealed	Repealed	Yes
Capital Gains Timber	Repealed	Repealed	Yes
ITC, Seven Year Amortization Reforestation Expenses	Repealed	Repealed	Yes
Capital Gains Iron Ore	Repealed	Repealed	Yes
Expensing Tertiary Injectants	Repealed	Repealed	Yes
AGRICULTURE			
Expensing Capital Expenditures	Modified	Modified	Yes
HOUSING			
Credit Union Exclusion	Retained	Repealed	Yes
Historic Structure Credit	Repealed	Repealed	Yes
Rehabilitation Credit	Repealed	Repealed	Yes
Five Year Amortization Housing Rehabilitation	Repealed	Repealed	Yes

Rapid Amortization of Low Income Housing	Repealed	Repealed	Yes
COMMERCE GENERALLY			
Excess Bad Debt Reserves	Repealed	Repealed	Yes
Safe Harbor Leasing	Repealed	Repealed	Yes
R&D Credit	Repealed	Repealed	Yes
TRANSPORTATION			
Shipping Company Definitions	Repealed	Repealed	Yes
EDUCATION AND TRAINING			
Targeted Jobs Credits	Repealed	Repealed	Yes
ESOPs	Repealed	Repealed	Yes
Expensing Magazine Circulation Costs	Repealed	Repealed	Yes
HEALTH			
Five year Amortization of Pollution Control	Retained	Repealed	Yes
INTERNATIONAL			
Controlled Foreign Corporations	No change	No Deferral	Yes
Domestic International Sales Corporations	Repealed	Repealed	Yes
Maritime Construction Fund Exclusion	Repealed	Repealed	Yes
Possessions Corporation Credit	Retained	Repealed	Yes
CHARITABLE			
Corporate Charitable Deduction	Retained	Deduct 1/2	Yes
CORPORATE REORGANIZATIONS			
Stock-Debt Swap Exclusion	Repealed	Repealed	Yes
Liquidation Nonrecognition	Repealed	Repealed	Yes

Source: Tax Notes, June 4, 1984, pp 1095-1100.

Representative **Hamilton**. I will ask our other two witnesses to come forward, please, Mr. Musgrave and Mr. Gramlich.

I understand Senator Kasten is not going to be able to appear. His prepared statement will be put in the record without objection.

[The prepared statement of Senator Kasten follows:]

PREPARED STATEMENT OF HON. BOB KASTEN

Mr. Chairman, I am pleased to testify before your subcommittee this morning to discuss fair taxation. My good friend Jack Kemp and I have sponsored the Fair and Simple Tax plan (S.2600/H.R. 5533) which we believe will provide the American taxpayers with much needed tax reform.

As this hearing this morning indicates, tax reform is a major issue in Washington--and all across the country. Every day we in the Senate and House of Representatives receive letters and postcards from constituents who are irritated, fed-up, dissatisfied, and just plain mad at our tax system. The bottom line is always the same--the American taxpayers deserve a tax system that is fair, simple, and yet provides incentives for savings, investment, risk-taking, and economic growth. It's time for an overhaul of our current tax system, and the Fair and Simple Tax plan will do it.

The Fair and Simple Tax (FAST) plan offers the best features of a flat tax--a single tax rate applied to an expanded tax base--with special provisions for the working poor, families, homeowners, savers,and small businesses. In brief, the plan caps the tax rate at 25 percent, doubles the personal exemptions, provides an employment income credit, and maintains the essential deductions in current law.

This is a dramatic change from the current tax system. Over the years, inflation and the progressive tax code have produced a climate in this country that encourages Americans to consume rather than save and invest. This consumption comes at the expense of economic growth and productivity. Theoretically, our progressive tax system raises government revenue fairly. In reality, the steep and progressive tax schedule provides an incentive to avoid activities that are subject to high taxes--activities such as work, savings, investment, and risk-taking.

And, as the economic climate suffers from rising marginal tax rates--the result of inflation and the progressive tax code--more and more taxpayers avoid taxes through legal loopholes and evade taxes by participating in the underground economy. As Congress passes laws which, in one way or another, exclude large amounts of income from the tax base, higher tax rates must be applied to the remaining income just to break even. As the tax rates rise, so does the incentive to avoid paying taxes--both legally and illegally. In fact, some economists and tax experts believe that this avoidance has actually led to a system that is less progressive in reality than on paper.

The American taxpayers are tired of a tax system that robs Peter to pay Paul--that grants loopholes for some, but not for everyone. In fact, depending on the source of income, and the opportunities to take advantage of tax preferences, taxpayers with the same amount of income can pay very different rates--and amounts--of tax.

That is why Congressman Kemp and I have put together the Fair and Simple Tax plan. We believe that our plan will be a welcome alternative to the current confusion and widespread inequality in the current tax code. The FAST plan provides a single low rate on income, and is simple enough to figure without a tax table. It broadens the tax base by eliminating most tax loopholes. But, we have been careful to maintain essential deductions for homeowners, savers, and families. We have not changed the current tax treatment of mortgage and other interest, property taxes, charitable contributions, and retirement pensions, and IRAs.

FAST also maintains the current law treatment of Social Security. Both the tax and benefit structure remains the unchanged. We are aware, however, that the Social Security tax is regressive. In fact, many lower income taxpayers pay more in Social Security (FICA) taxes, than they do in federal income taxes. To make sure that low and middle income taxpayers do not face a tax increase as a result of the interaction between the 25 percent tax rate and the Social Security marginal tax rates, we provide an employment income credit. Taxpayers earning less than $40,000 may exempt 20 percent of their earned income from taxation. This employment income credit--much like an expanded earned income credit--coupled with the higher personal exemptions work to actually lower taxes in many cases. The credit is phased out so that those earning more than $100,000 will not receive it.

And while Americans in the upper income brackets will have their income tax rate reduced from 50 to 25 percent, many of the tax loopholes they now use to shelter income will no longer be available. Paying a lower tax rate of 25 percent will be more agreeable to upper income Americans, and I believe that over time the Federal government will get more tax revenue with this plan.

FAST is a flat tax that doesn't shift the tax burden from the upper income to low and middle income taxpayers. FAST will also raise about the same amount in revenue as current law. While this is not typical of a flat tax, it doesn't make FAST any less a flat tax. As a flat tax, FAST solves many of the problems of a progressive tax system, such as the marriage penalty for a family with two income earners, the disincentives of increasing marginal tax rates as earnings increase, and bracket creep. Other leading tax reform measures--Bradley-Gephardt, for example--do not.

In fact, the Bradley-Gephardt Fair Tax--despite some obvious similarities--is very different from FAST. Both FAST and Bradley-Gephardt reduce marginal tax rates for individuals and corporations, and broaden the base by eliminating many deductions, exclusions, and credits. This, however, is where the similarities end, and the differences begin.

FAST has a lower top tax rate--25 percent, instead of 30 percent. And, since there's only one rate, FAST is simpler. The taxpayer won't need tax tables or a complicated system of surtaxes to figure out how much he owes the Federal Treasury. Bradley-Gephardt has many taxpayers figure their taxes twice--first, the taxpayer takes allowed deductions and credits and pays 14 percent of what remains. Then, the taxpayer with joint income over $40,000 must calculate and pay an additional 12 percent on expanded gross income. That's income with employer-paid health and life insurance, and no deductions. Effectively, Bradley-Gephardt caps all allowable deductions at 14 percent. With FAST, this doesn't happen. If a deduction is allowed, then it's allowed against the full 25 percent tax.

FAST is fair to the working poor. Even though both plans raise the tax threshold above the poverty level, FAST provides a broader cushion to those trying to get out of the poverty trap. Because of the high marginal tax rates, Americans receiving welfare payments hesitate to take a job for the same amount of money. The tax on the earned income leaves them with less money than they got through welfare. FAST raises the income tax threshold well above the poverty line--$11,101 for a family of 4--so that the choice between working and receiving welfare is avoided. Bradley-Gephardt raises the tax threshold, too, but only to $11,200 for a family of four. With FAST, a family of four doesn't pay tax on the first $14,375 of income. The result is that 1.4 million people are taken off the tax rolls--from the bottom.

FAST is family oriented. It doubles the personal exemption from $1,000 to $2,000, and increases the standard deduction to $2,700 for a single person or head of household and $3,500 for a couple filing a joint return. Both are indexed to inflation. The result of these deductions and exemptions is that a working family of four will pay no tax on the first $14,375 of income.

Exactly what does all this mean for individuals? The following examples show typical American taxpayers, the taxes they pay now, and those to be paid under FAST and Bradley-Gephardt. These are examples put together by Senator Bradley and Congressman Gephardt, with an adjustment for more realistic mortagage interest assumptions. Specifically, we assume that the value of each home is twice the taxpayer's annual income, that the mortgage is 75 percent of the value of the home, and that the mortgage interest rate is 12 percent. All we do show how FAST stacks up.

	1984 LAW	FAST	Bradley-Gephardt
Traditional family of four, $15,000 income........	$959	125	911
Traditional family of four, $30,000 income, and own home......................	2,695	2,275	2,788
Family of four, with two income earners, $60,000 combined income, and own home..	7,225	6,532	7,834

As the examples show, FAST provides tax relief to these Americans, while Bradley-Gephardt only provides minor relief to the traditional family of 4 with $15,000 in income. And, even though FAST does not retain the two-income earner deduction and the childcare credit, a family of four where both parents work will pay less in taxes than they do now. Bradley-Gephardt retains the child care credit, and yet the working family would face a $609 tax increase.

The traditional family also gets tax relief because we do not believe the tax code should discriminate against the non-working spouse who stays at home. Bradley-Gephardt would increase taxes on a traditional family of 4 with $30,000 in income.

FAST also provides incentives for work, saving, investment, and business enterprise. The treatment of capital gains is generous. The top corporate tax rate is cut from 46 percent to 30 percent. And the current accelerated depreciation schedules, enacted in 1981, are retained. Bradley-Gephardt elimates capital gains, the depreciation schedules, and does not provide a lower tax rate for small corporations.

In fact, FAST recognizes that millions of jobs are created in the small business sector, and has built in incentives for them. The corporate tax rate is 15 percent on taxable income up to $50,000. And, FAST allows expensing for up to $10,000 of business property.

FAST is a comprehensive tax reform package that will provide Americans the much need tax relief they demand--and deserve. Today, House and Senate conferees are meeting to resolve the differences in the 7th major tax bill in the last 10 years. And, when the bill is finally signed into law, the IRS and the American taxpayers will be more confused than ever. This is the result of years of overlapping and conflicting layers of tax legislation. It is only right that you, Mr. Chairman, are also holding hearings this week to explore various proposals to correct this problem. FAST is designed to bring efficiency and fairness into the tax code. I thank you for giving my distinguished colleague, Jack Kemp, and I the opportunity to discuss it with you.

Representative HAMILTON. We are very pleased to have both of you gentlemen with us. We have your prepared statements, Mr. Musgrave and Mr. Gramlich. Both of those statements will be entered into the record in full. We look forward to your comments.

We will begin with you, Mr. Musgrave.

STATEMENT OF RICHARD A. MUSGRAVE, PROFESSOR OF POLITICAL ECONOMY, EMERITUS, HARVARD UNIVERSITY, AND ADJUNCT PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA AT SANTA CRUZ

Mr. MUSGRAVE. Thank you, Mr. Chairman. I submitted a somewhat detailed discussion of the various reform proposals which are now before us, and I will simply touch on what I think are the major points.

Representative HAMILTON. Will you speak right into that microphone, sir. It will help us.

Mr. MUSGRAVE. Some of these proposals aim at reforming the income tax while another set of proposals aim at substituting a consumption-based tax for an income tax, and I will deal with these in turn.

With regard to the income tax reform proposals, the two plans which are primarily discussed are the Bradley-Gephardt and the Kemp-Kasten plans. They both, I think, are quite similar, and both deserve a lot of credit for proposing a broadening of the tax base which would then permit a rate reduction.

This idea of a broadening of the tax base, of course, is not something new at all. Tax reformers in my generation, beginning with Henry Simons, have been arguing for that for 40 years. And it is gratifying to find, after all these decades, that it is finally taking hold.

Certainly broadening the tax base by making the income base more comprehensive is all to the good. It's good as a matter of what we call horizontal equity to secure more equal treatment of people in equal positions. It is good on grounds of efficiency by reducing the incentive to seek tax havens. And it is good on grounds of simplicity. It's good all around, and both of these proposals are to be supported for that reason.

Of course, neither of them goes all the way. In both cases there are important omissions. For instance—and I think most important—take the tax references for housing. I suppose that if we could ask the sponsors of these bills off the record, they would probably say that one ought to go further but it can't be done politically.

Nevertheless, they push in the right direction, and that is a good thing. On the whole the Bradley-Gephardt proposal goes further, both in the pursuit of particular items and also in this rather interesting idea of permitting retained deductions only for the basic rate, and thereby making them taxable for the surtax rates of 26 and 30 percent, adding 30 minus 14 or 16 percent at which they would be taxable in the upper income groups, and I think that is an advantage.

Both these plans provide for a substantial increase in the tax free income floor, which is possible because of the broadened base. While maintaining essentially the same revenue, they both go substantially above present tax-free levels. That is especially so in the Kemp-Kasten plan because of their proposed 20 percent wage exclusion. Viewed as an additional exemption, that exclusion seems to be an inappropriate way of doing it. However, they propose it as an offset to the payroll tax, but I have my doubts about this as well.

With regard to rates, there is, of course, a substantial difference between the plans, with a flat rate of 25 percent in Kemp-Kasten as against the 14-, 26-, or 30-percent rate under Bradley-Gephardt. Now it should be pointed out, in fairness to Kemp-Kasten, that even though they have a flat bracket rate, their effective rate, which is the ratio of tax to income before exemptions, is progressive.

And, if we talk about progressivity, it is the effective rate that matters. So their effective rate is progressive over, let's say, the lower two-third of the income range, and here the two proposals don't differ very much because over this range the rising bracket rates don't really make much difference. Effective rate progressivity is controlled by the level of the exemptions. But they do differ substantially at the upper end in that Bradley-Gephardt continues progressivity over the upper ranges whereas under Kemp-Kasten the effective rate flattens off much earlier.

I favor the Bradley-Gephardt position because it seems to me that the principle of progressivity, that the effective rate of tax should rise with income, should not cease at a level of, say, $75,000. I think that is a sound principle.

And let me just make briefly three points on that.

To begin with, what one thinks is fair in the tax burden distribution, equity in the sense of distributive justice, is essentially a matter of one's own judgment, of what one considers to be a good society. My view that there should be continued progressivity over the upper ranges is in that sense a value judgment. I don't defend it as something that can be scientifically proven. Economists once thought they could do that, but we don't do that anymore. Nevertheless, that is my judgment of fairness. I realize that is somewhat out of step with the times, but hopefully, in time the times will straighten out on that point, toward the way I see it.

Second, and apart from this matter of value judgment, which I think is very important, there are some further and more technical considerations. One, is that progressive taxation as against a head tax invites the taxpayer to substitute leisure for labor. That is quite an inevitable price to pay. But I do not think that with a top-bracket rate of 30 percent, or even a 50-percent rate which I would prefer, this is a very serious consideration. The problem, to which the previous witness referred, of the underground economy arises not because the rate is 30 percent or 50 percent but because there are vast opportunities in terms of tax loopholes which permit the avoidance of these rates. I think that with the broadened tax base we could surely have a 30-percent rate or even a 50-percent rate.

However that may be, I think it is very important for this entire discussion to separate the question of base broadening, which inherently is linked with a proposal for rate reduction from the further question of whether this reduced rate should be flat or progressive. On base broadening, all well-meaning people should agree. On the rate structure, opinions will differ.

Third, I note there is a tendency for proponents of a flat rate to present that as a necessary part of simplification. I think that is wrong. Under the income tax, once the base is broadened, the simplification argument in favor of the flat rate is quite minor and indeed quite superficial.

Under an expenditure tax, that is different. Under the expenditure tax, a flat rate simplifies a lot, but not under the income tax. So I think these two things should be separated.

As far as the corporation tax is concerned, I much prefer the Bradley-Gephardt solution because I believe that the depreciation reform in 1981, which I think was scandalously bad, is still bad after the worst parts were removed in 1982.

However, there is one other point on which I entirely side with Kemp-Kasten, and that is the indexing. I think the indexing is the one good part of that unfortunate 1981 legislation, and it would be a shame to make it just that part which is being removed. I think you have got to have indexation, not only of rate brackets but also of capital gains, to make the income tax an honest tax. Lack of indexing is one of the reasons why the income tax has been demoralized.

I realize this is not a convenient position to be placed in, for Congressmen and Senators who, if indexing is retained, will have to vote for a larger rate increase. But I think indexing is a basic issue of income tax honesty, and it should be kept.

Now, very briefly with regard to the idea to move to a consumption tax base. There are, I think, two major proposals before us. One is an honest-to-goodness expenditure tax, as was proposed in the Treasury "Blueprints" in their publication of 1978, I think, and now there is another and much more simplified proposal for a flat rate expenditure tax which has been presented by Hall and Rabushka.

The full-fledged approach to an expenditure tax has its attractions. It may prove simpler than an income tax, as it certainly avoids some of the major difficulties. But it also adds others. If it were to be tried, I would say that it is too major a change to be made on a massive scale. Prudence would require that it be tried on a limited scale, perhaps over the upper brackets combined with rate reduction of income tax rates over those brackets.

I would add, however, that the gains in saving, which would result from such an expenditure, they probably would be positive, should not be exaggerated. They would be minimal and insignificant, compared to the increase in national saving which will have to be achieved by reducing Federal dissaving and doing away with the deficit. Anyone who is concerned with saving should spend his or her time on reducing the deficit before worrying about the relatively minor role of savings incentives in the private sector.

I must add that to make an expenditure tax acceptable, it would be necessary to include bequests into the expenditure base of the testator, allowing for proper averaging. I don't think it's enough to say that you can always tax the bequest if and when the heir consumes. Taxpaying ability should be related to the capacity of an individual during that individual's lifetime and it should not be put on a dynastic basis.

Therefore, if we want people with equal endowments and options to pay equal taxes, then bequest should be included as part of the option. I take it that the recent Brookings proposal proceeds along these lines.

Now with regard to the Hall and Rabushka plan. Their plan offers a very much simplified and clever procedure and this is possible for two reasons. Without going into details, one is that a flat rate is used, and the other is that there is a total disregard of transition problems, including tax avoidance via dissaving and drawing down of assets. Also, the plan has a flat rate of 18 percent which I find quite unacceptably low with regard to the upper brackets.

Let me end by saying that, having spent the last four decades or more on problems of tax reform—I do not say this lightly—tax reform is not the basic problem to where we stand now. The basic problem is to increase taxes to deal with the deficit and to permit a sustained recovery, not only in the United States but also in Western Europe, and especially in the developing countries. That is the important problem, to increase taxes and to increase taxes promptly.

The so-called down payment is absolutely minimal. And I think the public is being confused by this habit, which has developed recently, to cumulate revenue gains over 3 years. If we talk about a $50 billion revenue gain over 3 years, that means about a $22 billion annual rate in 1988, which is quite minimal compared to the annual rate deficit of $200 billion or more at that time.

To consider tax reform at this point is fine if it helps increasing revenue. But I am a bit worried that it may delay increasing revenue. Reform talk may become an excuse for postponing a massive attack on increasing revenue. Basic reform will take a year or two or three, but the revenue increase can't wait. It simply requires the guts to impose a very substantial surcharge before getting involved in the reform debate, that is No. 1, and the reform is second.

[The prepared statement of Mr. Musgrave follows:]

PREPARED STATEMENT OF RICHARD A. MUSGRAVE

Tax reform proposals now under discussion fall into two groups, those which reform the income tax by broadening its base while reducing rates and those which replace income with consumption as the designated tax base. The Bradley-Gebhart (B-G) and Kemp-Kasten (K-K) proposals belong to the first group, while the Hall-Rabushka (H-R) plan belongs to the latter.

A. Proposals for Broadening the Income Tax Base

The essential feature of the B-G and K-K proposals and of a number of similar plans is to broaden the income tax base by eliminating inappropriate exclusions and deductions.[1] This is obviously a desirable move, as equity, efficiency, and simplicity all stand to gain. Taking the income tax revenue for 1984 at $320 billion, the revenue shortfall due to incomplete base coverage is estimated at about $200 billion. Putting it differently, broadening the tax base would permit the same revenue to be obtained while reducing rates on the average by from 30 to 40 percent. Base broadening has been advocated for decades by my generation of tax reformers, beginning with Henry Simons and including Carl Shoup, Richard Goode, William Vickrey, Stanley Surrey, Joseph Pechman, and most other serious students of the income tax. Having been part of this effort for forty years, I am of course delighted to see the idea of base broadening gain popular support.

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[1] See Senator Bill Bradley's release of August 14, 1983, introducing the "Fair Tax Act of 1983," and the statement by Congressman Jack Kemp on the Kemp-Kasten "Fair and Simple Tax," dated April 26, 1984.

The Case for Base Broadening

The gains from base broadening, to repeat, include equity, efficiency, and simplicity, all the major criteria by which a good income tax should be judged. I consider them in turn.

Equity. The basic principle of income taxation is that ability to pay should be measured by a comprehensive index of economic capacity, which index is given best by the concept of accretion. Accretion is measured by the increase in a person's net worth during a given period plus his/her consumption during that period. What matter is this total measure of income, independent of the sources from which it is derived and the ways in which it is used. The present tax law falls far short of this requirement. Taxable income, as already noted, is reduced by numerous exclusions and deductions which, in combination, result in a tax base loss of from 30 to 40 percent. This would be a minor problem if the shrinkage rate was uniform across all taxpayers. But such is not the case. Some taxpayers benefit greatly while others gain little from these provisions. Gains accrue all along the income scale but vary greatly among taxpayers at any given level of income. Thus taxpayers who receive their income from tax-exempts or capital gains are treated much more lightly than others who obtain equal incomes in the form of wages. Or, taxpayers who carry large mortgages and enjoy large income deductions are treated more favorably than are renters with equal income. If these special privileges--once called loopholes and now referred to as preferences or tax expenditures--were done away with, these horizontal inequities would be avoided. The income tax would then be rendered a fair tax, and perception of fairness is essential if the tax institution is to function in a satisfactory fashion.

Efficiency. If tax liabilities are permitted to depend on the sources and uses of income, taxpayers will try to derive their incomes from low-tax sources and they will spend their money in ways which provide them with deductions from taxable income and are thus subsidized. Investment will be directed into channels where the income can be reaped in the form of capital gains or where depreciation allowances are especially favorable. Consumption will be drawn into uses such as owner-occupied housing and so forth. In this way preferential treatment, be it in the form of exclusions or deductions, distorts economic decisions and results in inefficient resource use.

Simplicity. The wide range of exclusions and deductions now permitted, finally, greatly complicate the taxpayer's compliance task. This, to be sure, if of lesser importance for the lower two-third of taxpayers who do not itemize but remain within the limits of the zero rate bracket, formerly and more intelligibly referred to as standard deduction. But for the upper third, the compliance cost is increased substantially. However, even here the gains in simplification should not be exaggerated. The point is that even if deductions and exclusions were abolished, it would still be necessary to properly determine the taxpayer's net income, i.e., to determine which items should be included as cost of doing business, how costs such as depreciations should be measured, and how capital gains are to be determined. Broadening of the income tax base, while greatly desirable in terms of tax equity, should not be confused, as it might be in the public mind, with the substitution of a tax on gross income. In all, simplification makes an important contribution but the primary gain from base broadening is in horizontal equity and the efficiency of the income tax.

Base Broadening under B-G and K-K

Both plans propose that a large number of special provisions--exclusions, credits, and deductions--be discontinued. Both plans move to full inclusion of capital gains, a major improvement in all (equity, efficiency, and simplicity) respects. B-G discontinue a large number of exclusions such as income earned abroad, life insurance interest, employer contributions to life and health insurance, interest on non-general obligation bonds, interest and dividends under sections 116 and 128, unemployment benefits, employer-provided child care assistance, and so forth. Deductions and credits to be discontinued include the elderly tax credit and the sales tax deduction. The deduction of consumer (other than mortgage) interest is to be limited. The K-K list is generally similar although it goes further in some parts as in discontinuing the deduction of state and local income taxes while being more limited in other respects, such as leaving deduction of consumer interest unchanged. Both plans retain deductability of IRA and KEOGH contributions, and the charitable deduction is left unchanged by both.

There is, however, one major difference between the two plans. This results from the B-G provision which limits the applicability of itemized deductions (including home mortgage interest) to the first bracket rate of 14 percent, while disallowing these deductions for the upper bracket rates of 26 and 30 percent. For taxpayers in these brackets, mortgage interest and certain other items thus become taxable at from 12 to 16 percent. This novel device might render partial taxation of such items acceptable, although the use of a ceiling or an across-the-board inclusion at a constant fraction would be preferable if a choice could be made.

The authors of both plans are to be congratulated for making a fine start towards the broadening of the income tax base. But it should also be noted that these proposals--restricted as they are by the need for political realism--fall considerably short of doing a complete job. Thus home owner benefits (mortgage interest and the property tax deduction) are left untouched (except by the just noted B-G upper bracket provision), as are the big areas of employer contributions to pension plans and the treatment of general obligation bonds. Nevertheless, the B-G and K-K proposals are a big step forward and much would be gained by their enactment.

Tax Rates and Exemptions

Having broadened the base, both plans then proceed to reduce rates. B-G leave the bottom rate at 14 percent and collapse the remainder of the rate structure into two rates of 26 percent (applicable above $40,000) and 30 percent (applicable above $65,000). K-K in turn propose a single and flat rate of 25 percent. At first sight, this suggests that K-K abandon the principle of progression but such is not the case. Consideration must also be given to the proposed level of exemptions, including the personal exemption and the zero rate bracket amount. What matters in judging the burden distribution is the pattern of effective rates, i.e., the ratio of tax to pre-exemption income, and this depends on both the level of exemptions and on tax rates. Given allowance for exemption, the effective rate of tax becomes progressive even if the applicable tax rate is flat. In fact, even under the present rate structure, the role of exemptions is much the dominant factor in determining the progressivity of effective rates for, say, two-thirds of all taxpayers.

Exemptions. Referring to the exemption structure for a family of four, we have the following comparison:

	Present Law	B-G	K-K
Personal Exemption	$ 2,000	$ 3,200	$ 4,000
Two dependents	2,000	2,000	4,000
Zero bracket amount	3,400	6,000	3,500
Wage exclusion	-	-	2,874
Earned income credit	1,240	-	-
Tax begins at	$ 8,640	$ 11,200	$ 14.374

The comparison shows that both proposals provide for a substantial increase in the income floor above which taxation begins, especially so under the K-K plan. It also shows that the increase under B-G derives largely from an increase in the zero bracket amount (standard deduction) whereas under K-K it results from increased exemptions and the 20 percent wage exclusion.

Tax Rates. B-G, as noted before, propose rates of 14, 26, and 30 percent, while K-K use a flat rate of 25 percent. Thus both raise rates at the bottom and reduce rates at the top.

Combined Effect. Combining proposed changes in exemptions and rates, both plans aim at an outcome (under the assumption of constant revenue) such that over the wide middle range of taxpayers, average rates of tax within the various income brackets remain about unchanged. At the same time, some taxpayers within each bracket will gain while others will lose, these adjustments serving to improve the horizontal equity of taxpayer treatment within each bracket. The K-K plan, however, will prove more favorable at both the lower and the upper end of the income scale. Such is the case because K-K sets a higher floor of taxable income and also provides for a lower top rate. As a result, the revenue loss due to these effects must be borne by somewhat higher effective rates over the middle income range.

The K-K proposal for an "employment income credit" of 20 percent up to $40,000 is an interesting but questionable innovation. For employees, it may be viewed as an additional exemption which rises in line with income, an arrangement which seems to run counter to the very idea of exemption which, if anything, should let the exemption vanish as income rises. Since taxpayers with capital income do not benefit from the provision (except for incomes below $10,000 which in any case are to be considered as wage income) the proposal introduces a differential treatment between income sources, which runs counter to the uniformity goal of base broadening. K-K, I realize, would not consider this a disadvantage, since they propose the wage exclusion as an offset to the payroll tax. This, however, does not seem to me a desirable way by which to replace the employee tax by a budgetary contribution, even if it were assumed that such a substitution is desirable.

Degree of Progression. The major difference between the two plans thus lies in their treatment of the upper end of the income scale where the level of exemptions is no longer important and effective rates come to be determined by the applicable bracket rate. Since this rate is higher under the B-G plan, their treatment of the upper range is more progressive than under K-K's flat rate. However, the difference is a moderate one only. Even the B-G top rate of 30 percent remains much below the present rate of 50 percent, not to mention the 70 percent rate of a few years ago.

To judge the merit of this rate reduction, it must be kept in mind that these preceding higher rates were applied to a diluted tax base only, whereas the new rates are to apply to a fuller base, in particular the full inclusion of capital gains. Given this improvement, a 30 percent rate which is effective and generally applicable is clearly to be preferred to a 50 percent rate which is not. However, this still leaves open the question of how high top rates should be applied to a full base. In short, there is a question of how progressive the rate structure should be, especially in its application over the upper range.

Few people, I suppose, would favor that government be financed by a head tax. Nor would many hold that the tax should be proportional from the bottom up. From Adam Smith on, it has been generally held that some minimum level of income should be exempt and all the current proposals are agreed on this. Indeed, as noted before, the floor of taxable income is to be raised. Thus both B-G and K-K agree that the effective rate of tax over the lower-middle income range should be progressive. But if the rate is flat, the effective rate will level off sooner (and progression taper off) than if rising bracket rates are used. B-G and K-K differ therefore over the higher range.

Fifty years ago, economists thought that the case for progressive rates could be proven in a scientific fashion, based on the proposition of decreasing marginal utility of income and comparability of utility schedules. This view is no longer held. Whether progressive rates are desirable or not depends on what society considers to be a fair distribution of the tax burden or, more basically, of income. Using professional jargon, the outcome depends on the shape of the "social welfare function." Different people differ in their view of distributive justice, and a social consensus has to be reached on which policy can be based. As I see it, progressivity is appropriate not only over the lower but also over the middle-upper and high income range. In my judgment, a top bracket rate of 50 percent is appropriate, even if fully applied, especially so in view of the fact that a high and increased level of income tax revenue will be needed.

At another level of argument, the problem is not one of social philosophy but of economic effects. Higher marginal rates of tax are more apt to distort economic decisions and involve efficiency costs. In the extreme case, they may even lead to reduced revenue. But the rates proposed by B-G and K-K are not in that range, nor do I think that a 50 percent rate is. Moreover, it should be kept in mind that if rates at higher levels of income are reduced, those over the middle range must be increased if the same revenue is to be obtained. Thus, incentive gains achieved from the former must be balanced against potential losses due to the latter. Under both plans, but especially under K-K, a substantial number of low to middle income taxpayers will find their marginal rate increased above current levels. It is thus not at all evident that efficiency cost is reduced on balance.

Simplicity. Equity and efficiency costs aside, it is also suggested that a flat rate has the great advantage of simplicity. This point has some merit, especially in the context in which the corporation tax is to be integrated with the individual income tax, but neither plan suggests this. Apart from integration, the simplicity case for the flat income tax rate is easily exaggerated. This is so especially since both plans provide for full inclusion of capital gains. Insofar as computation of the tax is concerned, rate progression can be allowed for easily through tax tables, reference to which is no more (and perhaps less) difficult than multiplying taxable income by the flat rate. What matters most for income tax simplicity is base broadening. The flat rate is of minor importance and should stand on its own legs.

Indexing

Before leaving the income tax, I want to note the B-G proposal to repeal the indexing provision, while K-K retain it. My view here is strongly on the side of K-K. Indeed, I consider the indexing provision the one good feature of the otherwise unfortunate tax legislation of 1981. Failure to index and to permit bracket creep to occur, in my view, has been a major source of income tax demoralization. Congress should not be permitted to reap the gain of increased revenue from hidden rate increases and without having to legislate increased rates explicitly. While I recognize that retention of indexing will increase the amount of additional revenue which Congress must legislate to close the structural gap, I do not consider this a reason for indexing repeal. I would like to see the B-G plan amended to retain it.

B. Corporation Tax Proposals

In passing, let me note briefly that both the B-G and K-K plans also contain proposals for the corporation tax. Both reduce the rate from 40 to 30 percent, but neither deals with the basic problem of integrating the taxation of corporate-source income with the individual income tax. Both repeal the investment credit but K-K retain the current depreciation provisions while B-G propose a substantial depreciation reform and also repeal percentage depletion. While the more extreme flaws of the 1981 law were corrected in 1982, the present law is still far from satisfactory. The B-G proposal offers a substantial improvement and I strongly prefer it in this respect to the K-K plan.

C. Consumption Taxes

I now turn to a more drastic departure from past practice, i.e., proposals which would transfer the tax base from income to consumption. Traditionally, the taxation of consumption was viewed in the form of in rem taxation, be it via a retail sales or a value added tax, and as such it was criticized for being regressive. But lately the taxation of consumption has been proposed in the form of a personal expenditure tax, which allows for exemptions and may make use of progressive rates. The stigma of regressivity has thus been removed, permitting the taxation of consumption to become more or less similar in this respect to an income tax. A careful and comprehensive proposal for a progressive expenditure tax was outlined in the Treasury's 1977 tax reform study[2] and a much simplified and quite different plan for a flat rate consumption tax has recently been proposed by R. Hall and B. Rabushka (H-R).[3]

Expenditure Tax

As developed in the Treasury's 1977 study, the implementation of a progressive expenditure tax defines the individual's tax base as the sum of cash income plus net borrowing minus net investment. A set of financial accounts is developed to trace these items for each taxpayer. Having thus determined a person's tax base, exemptions and progressive rates are applied, as they are to AGI under the income tax.

Feasibility. The technical problems involved in such a tax have been examined at great length and cannot be recounted here. Some major difficulties of the income tax (e.g., the determination of net income, the problem of capital gains, and the measure of depreciation) are avoided. Other difficulties, such as the distinction between consumption and investment, gain in importance. A particular set of problems arise in the transition period and so forth. However, the weight of opinion is that a progressive expenditure tax is feasible and after adjustment to transition problems may prove somewhat simpler to operate than the income tax. Still, only practice can tell and it remains to be seen what new evasion devices tax lawyers might develop after an expenditure tax was introduced. For this reason, a massive transition from income to expenditure tax would clearly be unwise. A more limited exploration, restricted perhaps to high income brackets, would be called for as a first step.

Equity. Unlike a retail sales or value added tax, the expenditure tax may be rendered progressive. By allowing exemptions, the effective rate (ratio of tax to pre-exemption expenditure base) rises when moving up the income scale, even if a flat rate was used; and progressive rates may be applied to extend progressivity through the middle and upper brackets. If extension of such progression is called for under the income tax, it should surely also apply (or more so) under an expenditure tax.

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[2] Blueprints for Basic Tax Reform, Department of the Treasury, Jan. 17, 1977.

[3] Robert E. Hall and Alvin Rabushka, Low Tax, Simple Tax, Flat Tax, 1983. New York, McGraw Hill.

As in the case of the income tax, the horizontal equity of the expenditure tax will depend upon the comprehensiveness of the tax base and the absence of preferential treatment of particular types of outlays. Thus, if housing were to be exempted from the base, the omission would be similar to that resulting from preferential treatment under the income tax. Perhaps this might be avoided, but one wonders whether the same political pressures which are now so effective in curtailing the income tax base would not also reappear under an expenditure tax. Certainly it is misleading to compare an actual and defective income tax with a hypothetical and perfect expenditure tax.

There remains the basic question as to which--income or consumption--is the better tax base. A traditional argument in favor of the consumption base has been that people should be taxed on their "enjoyment" which is consumption, and not on their saving, which is set aside for the "common good." This proposition, which goes back to Thomas Hobbes, may well be questioned. People do not save to do good, but to accumulate wealth and to consume later. Economists arguing in favor of the consumption base have taken a different tack. They have argued that the income tax is discriminatory because it distorts a person's choice between present and future consumption, whereas a consumption tax is neutral. Under the latter, people who begin in the same position will pay the same tax (in present value terms) whether they consume now or later. Under the income tax, those who consume later will be penalized. Neutrality may be achieved in two ways. Looking at the sources side of the household account, it may be achieved by excluding capital income from the income tax, making it a tax on wage income only. Looking at the uses side of the household account, neutrality may be achieved by taxing consumption while excluding saving from the base. Assuming that a taxpayer has no net saving over his lifetime (dissaves later what he sets aside earlier), a tax on consumption is in effect similar to a tax on wage income.[4]

Which of the two approaches is to be preferred on fairness grounds remains debatable, but two points should be noted. For one thing, the claim that the consumption tax is neutral overlooks the fact that saving is undertaken not only to permit future consumption but also to enjoy the pleasures (security, power, etc.) of wealth holding. The other is that not all saving is turned into consumption during the saver's lifetime. Because of this, the expenditure tax may not only postpone the time when a tax becomes due, but the saver may never be taxed. This, I think, is an unacceptable feature of an expenditure tax, such as outlined in the Treasury's study. I am not satisfied with the argument that the tax will come to apply if and when the heirs consume. Tax equity, as I see it, should relate to particular taxpayers during their lifetime, and not be viewed in dynastic terms. The expenditure tax base, therefore, should be defined so as to include bequests. This consideration is the more important now, since the Federal Estate Tax has been largely dismantled by the 1981 legislation.

Incentive Aspects. The expenditure tax, by exempting capital income from taxation, increases the award for saving and may be expected, therefore, to increase the savings rate. Economists differ on how large this effect will be, but it may well be of some importance. However, this is not the entire story.

First, the comparison should not be between an expenditure tax and an income tax which offers no savings incentives. Such incentives are now offered under the income tax and their structure could be improved so as to render the savings incentive more effective while at the same time doing less damage to horizontal equity.

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[4] Suppose our taxpayer has a wage income W received at the beginning of the period. Of this, he consumes αW at once while $(1 - \alpha)W$ is saved, permitting him to consume $(1 + i)(1 - \alpha)W$ later on. The present value of his lifetime consumption C^L is given by:

$$PVC^L = \alpha W + \frac{(1 - \alpha)W\ (1 + i)}{1 + i}$$

or $PVC^L = W$.

Since the present value of consumption equals wages, the present value of a tax on consumption is equal to the present value of a tax on wages.

Secondly, fiscal policy may affect the savings rate of the economy more directly and powerfully by adjusting the rate of saving in the public sector. A budget surplus is equivalent to public sector saving, whereas a deficit is equivalent to public sector dissaving. The large structural deficit now built into the federal budget results in a rate of public sector dissaving vastly larger than what might be expected from increased private sector saving induced by substitution of an expenditure for the income tax. Anyone concerned with increasing the economy's rate of saving should thus put first things first and address the problem of the federal deficit. I will return to this point in my concluding remarks.

"Simple Flat Tax"

It remains to note an alternative consumption tax plan which has recently been proposed by R. Hall and A. Rabushka under the heading of "Simple, Flat, Tax." Under this plan, individuals are taxed on their employment income at a flat rate of 19 percent, while business pays the same rate on gross receipts after deducting wages, purchases of material, and investment. Thus, business is taxed on that component of its gross receipts which is paid out in dividends or interest, but not on what it invests. The business tax may thus be viewed as withholding the shareholder's tax on non-wage income, minus what he/she invests. Adding the two taxes, we arrive at a tax on consumption.[5] Assuming that there is no net saving over the individual's lifetime, this again equals a tax on wage income.[6]

Given that the H-R plan equals a flat rate tax on consumption, how does it relate to other taxes of the same type, e.g., a consumption-type valued added tax or a retail sales tax? While essentially similar, two differences should be noted. First, the H-R plan provides for a substantial personal exemption. Set at $7,700 for a joint return with two dependents, the H-R tax floor is below that given by B-G and substantially below that of K-K, but approaches that under the present income tax law. By providing this exemption, the effective rate under H-R is progressive for a substantial part of the range. While proposals have been made to apply an exemption under a value added or retail sales tax, this is difficult to implement and it may be that the H-R approach offers a better solution. However, the H-R plan does not reach consumption which is financed from dissaving, whereas such consumption is reached by the value added or retail sales tax. Assuming that the exemption problem could be solved, and that a flat rate was agreed upon, outright resort to a value added or retail sales tax would seem preferable.

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[5] We may think of income Y as consisting of business income B and wage income W. Thus $Y = B + W$. But income can also be seen as the sum of consumption plus investment, thus $Y = C + I$. We thus have $B + W = C + I$ or $B + W - I = C$, where the left side is the H-R tax base.

[6] See note 3.

Comparing the H-R plan with the full-fledged expenditure tax, three differences may be noted. To begin with, H-R has the advantage of being much simpler. Second, H-R has the disadvantage of not accounting for transition problems. Third, H-R has the major defect, as I see it, of requiring a flat rate. Much more so than under the income tax setting, simplicity under the expenditure tax vastly benefits from the use of a flat rate. Once the flat rate is dropped, business source income must be imputed to specific owners and the simplicity of the H-R scheme collapses. Whereas H-R view the flat rate as desirable in itself (and not only as a means to simplification), a flat rate consumption tax at 19 percent seems unacceptable to me on equity grounds. While exemptions permit progressivity in the effective rate through the lower-middle income range, the flat rate does not provide for an adequate share of the tax load at the upper end of the scale. This is especially so since consumption as a percent of income tends to fall when moving up the scale. As I see it, this loss of tax equity decidedly outweighs H-R's simplicity gain.

D. Tax Reform and the Deficit

I now move to a final and unhappy point. This is that the issue of tax reform is not the most burning problem on the immediate tax policy agenda. The most burning problem is to obtain increased revenue so as to meet the structural deficit that is ahead. If the drive for tax reform can help in this endeavor, that will be all to the good; and if providing for increased revenue can help towards tax reform, that would be fine as well. But I am worried that the search for reform may be permitted to sidetrack concern for early and substantial action towards increased revenue.

While the tax reduction of 1981 was helpful (by the logic of neo-Keynesian, rather than supply-side, economics) in promoting recovery, it has now led to a fiscal-monetary policy mix which must be redressed if a substantial recovery is to be achieved, not only in the U.S. but also in Europe and in the LDCs. The health of the world economy should not be made hostage to the mistaken proposition that tax reduction will force expenditure cuts--even if such cuts had merit. Nor should the primary burden of a bulge in defense outlays be concentrated on social programs. It should be spread widely across the economy, including the private as well as the public sector. A substantial tax increase is thus needed, and the "down-payment" now under discussion is only a very small beginning. The public, I fear, has been misled by the practive to feature the cumulative revenue gains of a tax package over a three-year period. What matters is not that the "down-payment" will result in a cumulative revenue gain of $75 billion over the years from 1984 to 1988, which sounds like a substantial sum. Rather, the point is that the annual revenue gain by 1988 will only be around $20 billion which is no more then one-tenth of the gap that is to be closed. To deal with the problem, a substantial recoupment of the revenue loss suffered from the 1981 legislation will be necessary, and such action, I believe, cannot wait for the inevitably protracted debate over comprehensive tax reform. Having been associated with the case for tax reform over many decades, I do not find this an enjoyable conclusion but I think it is the responsible assessment of the current situation.

Representative **Hamilton**. Thank you very much, Mr. Musgrave. Your prepared statement, and indeed the prepared statement of Mr. Gramlich, was just excellent.

The bells have just rung. That means I have to vote. I'll run over and cast that vote and come back, so we'll have a 15- or 20-minute recess. There's a quorum call, and that quorum call is to be followed by a 5-minute vote, so it will take about 20 minutes, I suppose.

The subcommittee will stand in recess.

[Whereupon, a short recess was taken.]

Representative **Hamilton**. The subcommittee will resume its sitting.

Mr. Gramlich, we will begin with your testimony. You may proceed, sir.

STATEMENT OF EDWARD M. GRAMLICH, PROFESSOR OF ECONOMICS AND PUBLIC POLICY, UNIVERSITY OF MICHIGAN

Mr. **Gramlich**. Thank you, Mr. Chairman, for inviting me to appear today.

I have one initial comment, and that is that we are considering the fair tax of Bradley-Gephardt and the FAST tax of Kemp-Kasten, and I wonder if I should read anything into the fact that all these tax plans are called by four-letter words beginning with "F." [Laughter.]

Now, on the details of the two tax plans, it is clear that I am about the last snowflake on the iceberg. You have had hearings for a long time and there has been a lot of discussion of the various provisions, and in addition to that it's getting late. So I'm not going to go into a very detailed criticism of the two measures.

Some of the things that struck me are listed in my prepared statement, and I will stand on that. Obviously, if you want to ask questions, that's fine.

Plus, I would like to say that when I heard Professor Musgrave make general comments on the two bills, I couldn't find one thing that I disagreed with. That is in part because a lot of what I think and have learned about taxes I learned from him, but there is even independent agreement on some things that have not come up until quite recently. So I don't have too much to add there, either.

But I would like to use the soap box in the brief time that I have to make one plea on all of this tax reform business, and it is really the same plea that Professor Musgrave ended with.

We do, of course, need tax reform. Nobody likes the system very much. We have any number of loopholes. There is quite a significant, perhaps massive, misallocation of productive resources. But I do think that tax reform is really the second issue, that the first issue is capital formation.

I just mention a few facts in the paper. I can provide backup for each of them. One fact is that the United States now invests much less of its total output than do all other OECD countries. We are not even close to Japan. We have, as everybody knows, experienced in the past 10 or 12 years a quite dramatic productivity slowdown from earlier years. The impact of ERTA and the rise in defense spending, according to some other calculations that I have done, seems likely to reduce the share of total output devoted to capital formation by another 30 percent.

By the way, I just checked that calculation with the data from the President's new economic report on the plane as I was coming down, and in 1983 we were right on track there. There has been a drop in the share of output devoted to capital formation from 5 years earlier. It's 5-percent of total output.

One way to put this that brings it down to average people is that, at the rate we're going, in effect the consumption binge implied by the fact that we are not paying for the growth in defense spending by taxing presently alive people, that the present generation of American adults is adding to the capital stock so little that we will be the first one in American history that actually has higher consumption standards than our children.

I think this is scandalous. It breaks some sort of intergenerational compact that is never carefully described or stated but that has been upheld for a long time now. A large part of the problem is directly due to the tax changes made in 1981, and something should be done about those. We do need more revenue, and tax policy is the obvious way to get more revenue, and I hope that issue doesn't get lost sight of in the discussion of tax reform.

Now, there are basically two things that could be done about this capital formation problem. As you have no doubt observed, in my statement I expressed a little disappointment. The disappointment was that it seems to me that we do have an opportunity now to do something about capital formation. And I am a little disappointed in both of the tax plans because they don't do very much about it.

There are essentially two ways to deal with the problem. One is that tax reform can increase Government revenues so that in these terms aggregate consumption of present generations goes down and aggregate capital formation goes up.

The second is that tax reform can alter incentives so the private sector is encouraged to save more and also more efficiently.

Now, there were some very slight changes in the 1981 bill that went in the direction of point B, the efficiency changes. Actually, it's ironic but the major change there, at least in that direction, was the treatment of producers' investment was made so much more favorable that the distortion implicit in the differential treatment of housing and producers' investment was substantially reduced. And that actually improves, I think, to some degree, the allocation of capital. At least I take as the backup for that statement some articles that are appearing these days on tax distortion.

But alas, as I think everybody knows, and most people agree, the loss in revenue through the rise in Government dissaving from the large tax cuts was so much greater that the overall effect of the 1981 bill and was very, very negative on capital formation.

What I'd do about that, it again follows, is to raise revenue. I read through the material that was sent me by the staff, and both of the congressional sponsors of the various bills seem to be quite proud of the fact their bills would not raise revenue. I understand from a political standpoint why they would be proud and why they would praise that as an asset. I'll leave getting around all the political constraints to people who are professionals in that, and I am certainly not one of those. But as an economist I consider that a problem, not a solution, and it is one reason I am not very favorably disposed to the two bills.

I think while you are at it you do have to raise revenues. I realize it's unpopular. I realize that you will have all the lobbyists and you will have all the people that have to pay these taxes and so forth, but I'm just reporting my feelings, given the previous reasoning.

I have since been informed that there are variations on the Bradley-Gephardt bill that do raise revenue. If that is so, I'm for that, and the more the better—not without limit, obviously. I am not going to totally disagree with Congressman Kemp on that. But at least until we do something significant about the deficit, that's where I am on the question of the general level of rates.

On the structural changes, there are basically four areas where I think there are significant problems involving saving and investment in the present Tax Code. One involves the treatment of housing. One involves the tax arbitrage question, the fact that you can borrow and deduct the taxes on the interest and invest tax free. One involves investment incentives working mainly through the corporate tax. One involves treatment of capital gains.

I have gone through my reasoning in the statement and I'm not going to repeat it here. In every case the misallocations are improved by both bills, I will say that. The reason is that by the base-broadening and reduction of rates in general, you get less tax distortion. There is no question of that, and that's nice. And I would also like to make a particular commendation of whoever thought up this nice trick in Bradley-Gephardt of just deducting interest and things like that from the 14-percent rate and not from whatever the taxpayer's rate at the margin is. I think that's neat and I hope it stays. I bet it won't once it gets fully discovered, but anyway it seems a good go.

So all of that is nice. But I think, as you all probably know, there is not what I would call a frontal assault on the problems that generate the misallocation in any one of those areas. That is, the interest deductibility of housing is left there, the tax arbitrage problem is basically uncorrected, although in Bradley-Gephardt its damage was reduced by the 14-percent provision. There is improvement of the tax treatment of investment by eliminating the investment credit. And on the depreciation schedules, one source that I believe can be cited against Congressman Kemp's apparent agnosticism about whether ACRS is an appropriate measure of true economic depreciation is the President's economic report of this administration which seems to feel that the ACRS does not very closely approximate true economic depreciation.

So there are some improvements in all of those areas, but not what I would describe as total elimination of the things that lead to tax distortion of investment.

But I would like to agree with what Professor Musgrave said earlier. People have done estimates of how much capital we lose from all these distortions, and they are rather small. They are maybe 5 percent, 10 percent, or so of the capital stock—10 percent at most. That would be a very high estimate. And the amount of capital that we lost in the rise in deficits that followed from the 1981 tax changes and the rise in defense spending, which both had a role, was much, much larger than that.

So I think that really stands as the first problem. And tax reform, while nice and nobody is against it—and I am not, either—does stand as the second problem. I hope in all of this that the Congress does keep its eye first on what I feel to be the first problem.

Thank you.

[The prepared statement of Mr. Gramlich follows:]

Prepared Statement of Edward M. Gramlich

Thank you for inviting me to appear before you today. I have been asked to comment on taxes, and in particular on two plans for reforming them that go by the name of the Fair Tax (Bradley-Gephardt) and the Fast Tax (Kemp-Kasten). Why is it that all tax plans are called by four letter words starting with F?

Before getting into an analysis of the two bills, I would like to start with a plea. Of course we need to reform our tax system -- nobody likes it, loopholes abound, it causes massive misallocation of productive resources. But in the topic on the table today, I see an even bigger problem than that of reforming taxes. It is capital formation -- the fact that the U.S. now invests much less of its ouput than do all other O.E.C.D. countries, the fact that the U.S. is experiencing a dramatic productivity slowdown, and the fact that the 1981 tax changes and the rise in defense spending seem likely to reduce national capital formation by another thirty percent. According to some calculations I have done, the present generation of American adults is adding to the national capital stock so little that we will be the first in American history to live better than our kids. That is not a very appealing distinction, and I would like to use tax policy to remove it. Accordingly, in my remarks I will focus exclusively on this fundamental issue, ignoring some desirable and some undesirable changes that both Bradley-Gephardt and Kemp-Kasten make on progressivity, administrative simplicity, and a host of other items.

The capital formation issue is, of course, directly tied up with the deficits. Just so there is no confusion, the deficits are very bad for NATIONAL capital formation. There were some changes in the 1981 bill that stimulated, or attempted to stimulate, private saving and investment, and would seem to favor capital formation. But these slight changes were totally overwhelmed by the fact that the deficits either encouraged consumption and hence left no resources over for capital formation, or crowded private investment out of credit markets. You can take your pick, the two arguments amount to the same thing. The result is that the public dissaving overwhelmed the private saving increase, national saving and investment were reduced, and we are in effect stealing capital from future generations through our public sector dissaving.

The next question is how tax reform can help to solve the problem. Basically there are two ways, both of which are powerful:

a) Tax reform can increase government revenues, so that aggregate consumption goes down and aggregate capital formation goes up;

b) Tax reform can alter incentives so that the private sector is encouraged to save and invest more, or more efficiently.

The first way works by increasing the total amount of resources devoted to capital formation; the second mainly by improving their allocation.

What is disappointing about both Bradley-Gephardt and Kemp-Kasten is that neither does much in either direction. Both bills take pains to say they are not going to raise revenue. Why, for Heavens sake? The country needs more revenue. Both do broaden the tax base and hence have lower marginal rates, and this does reduce the tax-induced distortions in the treatment of various investments and will improve the allocation of capital. But beyond this general base-broadening effect, neither does very much about tax structure as it pertains to investment and saving. Both stick pretty much with the present income tax structure, or really a hybrid income-consumption tax structure we have developed in recent years that works against capital formation. Again why? Now, when almost everybody agrees that tax treatment of capital income has to be changed, seems like a golden opportunity to make some long-needed investment-saving reforms, and for the most part neither bill does so.

On my double agenda, it should be fairly well understood how tax changes can reduce the government's drain on overall saving by increasing revenue, so I will not discuss that option today. What I will discuss are a few of the ways that our present tax structure works against efficient capital allocation, what could be done to correct the problem, what the two bills under consideration do, and why I feel they miss some desirable opportunities.

1. The treatment of housing. By all odds the biggest problem in our tax structure, as it pertains to saving and investment, is the treatment of housing. The present system allows homeowners to deduct their interest cost, but does not force them to report their asset income, the imputed returns they get from owning a home. It also leaves untouched most capital gains owners get from owning homes. These are big loopholes, whether in an income or a consumption tax system. They encourage capital to flow into housing and away from other forms of investment, and hence cause a misallocation of that capital we do have. The proper tax treatment, used in certain European countries, is simply to include both the imputed income from owning a home and the gains on selling a home as part of the tax base. Failing that, a less radical

way to correct most of the problem would be to prevent taxpayers from claiming interest on any asset where they are not claiming the returns as income. If they do not claim imputed interest as income, they do not get to deduct mortgage interest.

The housing loopholes are very popular, appealing both to President Reagan and Presidential candidate Mondale. But they should be curbed. The Kemp-Kasten bill does very little about curbing them, apart from reducing their damage through the general cut in marginal tax rates to 25 percent. The Bradley-Gephardt bill doesn't attack them forcefully either, though that bill contains a neat trick that does cut down on the misallocation from the loopholes. Bradley-Gephardt makes all deductions deductions just against the 14 percent base tax rate. Hence for somebody in a higher bracket, and most itemizers would be, the tax subsidy for housing is significantly reduced. I do applaud this feature of Bradley-Gephardt, though still expressing disappointment that neither bill takes the opportunity to clear up what economists think is the biggest reason our present tax system leads to a misallocation of capital.

2. Tax arbitrage. Related to this problem is another. In the 1981 bill provisions were added to allow tax free saving in the form of IRAs, Keough Accounts, and the like. This seems like a step that would increase saving and capital formation. But the problem is that since the interest exemption was not curtailed, it becomes relatively easy for taxpayers to borrow, deduct their interest, put the money in an IRA, and get the benefit of tax free interest. Or, taxpayers can sell taxable assets and buy tax free assets. Personal saving is not stimulated at all, only asset shuffling. Neither bill curbs this loophole, apart from

the general cut in rates mentioned above. Since I favor a consumption tax, 1 do support the IRA and Keough provisions, but they should not be introduced without curbing the interest deduction -- that just defeats their purpose. I would be more positively inclined to the bills you are considering if either did something about this loophole.

3. Investment incentives. Both bills curb corporate tax preferences, and then return the revenue by cutting the corporate rate to 30 percent. Both changes work slightly in the direction of improving the tax treament of corporate investment, but as above, neither bill makes the significant changes that would provide for neutral tax treament of investment, and hence make for an efficient allocation of the corporate capital stock.

The Bradley-Gephardt bill eliminates the investment credit, which now favors investment in equipment over that in structures, and also returns to pre-1981 depreciation conventions. Most opinion that I've heard indicates that these pre-1981 schedules more closely approximate true economic depreciation, so this change, or this reversal of the 1981 change, would also eliminate the subsidy of very long-lived assets that can now be written off very quickly. Kemp-Kasten makes the first change but not the second.

While these changes, especially those of Bradley-Gephardt, would make a start at improving the tax treatment of corporate capital, several longstanding problems with business taxation go untouched. There is still a tax subsidy of debt as opposed to equity finance of investment. Inflation can still distort the tax structure, both because nominal interest is the interest that is deductible and because historical cost depreciation misstates true economic capital cost, by an amount that differs according to the life of the asset and the inflation rate for that type of good. And firms' tax treatment of their investment still depends on their own previous tax liabilites -- now losing firms without tax liabilities are denied the tax subsidies that are generally available; with these changes, losing firms will be spared the investment taxes generally imposed.

There are some ways to tax corporate income so as to reduce tax distortions even more. One, that eliminates the inflation distortion, is to let firms deduct the entire present value of their future depreciation allowances on an investment when they make the investment. A second, more radical but also more efficient because it also eliminates distortions due to misstating economic lives and the debt-equity choice, is to provide for consumption tax treatment within the corporate tax. This treatment would permit the immediate expensing of all corporate investment, and simultaneously eliminate the interest deduction in defining corporate income.

4. Capital Gains. The present tax structure taxes capital gains improperly in three, partly offsetting, ways. For one thing, it does not distinguish paper gains due to inflation, which should not be part of an income tax base, from real gains that should be. For another, it tries to rectify this problem by taxing gains at a lower rate, 40 percent of the taxpayer's normal marginal rate. For a third, it doesn't tax any gains at all at death, and hence allows tax-free accumulation of large estates across generations. Of these three problems, Bradley-Gephardt resolves the second but not the other two; Kemp-Kasten resolves the first but not the other two. Neither bill contains what I would find to be a satisfactory treatment of capital gains taxation.

Summary. In each of these four areas the pattern is similar. Both of the bills under discussion, because they broaden the tax base and make some desirable reforms, do move towards a more even-handed tax treatment of investment and saving, one that should cut down on the tax-induced misallocation we have now. But they move rather timidly, and would not improve the allocation of capital very much. They also would not raise overall capital formation very much, indeed perhaps not at all, because they are intentionally designed not to increase present tax liabilities, or reduce present-day consumption. Perhaps I should cheer because five to ten percent of the capital formation lost in the 1981 tax changes is restored. But frankly, my main reaction is a lament that this golden opportunity, when almost everybody is worried about deficits and many people are worried about capital formation, is not used more advantageously. On the whole, it would be better simply to eliminate the 1981 tax changes than to pass either bill. In that sense, my enthusiasm for both bills is contained.

National capital formation is a very large problem today. Whether by raising the overall level of taxes, or by making more far-reaching changes in the tax structure, we must do more about it than these bills do.

Representative **Hamilton**. Thank you very much.

Gentlemen, I am beginning to run up against some time problems with other commitments. I am anxious to get your general views.

I take it you both prefer Bradley-Gephardt over Kemp-Kasten; is that right?

Mr. **Musgrave**. Yes.

Mr. **Gramlich**. Yes.

Representative **Hamilton**. And you both prefer Bradley-Gephardt and Kasten-Kemp over the present code?

Mr. **Musgrave**. Yes.

Mr. **Gramlich**. At a given level of revenues, yes.

Representative **Hamilton**. Sum up for me, if you would, why you prefer Bradley-Gephardt over Kemp-Kasten.

Mr. **Musgrave**. Well, I prefer it for a number of reasons.

First, is that it pushes further toward base-broadening in a number of specific points, especially via this 14-percent provision.

Second, I prefer it because it sets a somewhat higher marginal rate at the upper end.

Third, because it moves in the direction of a better depreciation system.

Representative **Hamilton**. You think it would be improved, if I recall your testimony, by indexation?

Mr. **Musgrave**. It would definitely be improved.

Representative **Hamilton**. Would it be fair to say that that is the single major improvement you would recommend in Bradley-Gephardt?

Mr. **Musgrave**. Yes; correct.

Representative **Hamilton**. Mr. Gramlich, would you answer the first question?

Mr. **Gramlich**. Yes, I will.

My three reasons are the same, and I would say that in each case, while I have been critical of the reform as not going all the way, I think it is at least a valuable precedent to get embodied in the Tax Code that deductions get deducted against just the bottom bracket rate and so forth. So I would give the same three reasons.

On indexing, I am not quite so strong on indexing as I think Professor Musgrave is, but I would make two points.

There are two indexing problems.

One is when inflation happens, it dramatically misstates capital income and leads to all kinds of distortions. And that kind of indexing I think everybody is in favor of getting rid of, including me. That involves indexing capital gains. It should also involve just allowing deduction on real interest payments, not nominal interest payments, and so forth across the board. There are any number of capital income items that get misstated.

On the general question of indexing of brackets so that we don't have bracket creep caused by inflation, it is, of course, dishonest to have that kind of bracket creep and nobody is going to come out with something that is explicitly dishonest. But I think there's another kind of not dishonesty but irresponsibility that's going on, and that is our general tax rates are too low because we are not paying for the public goods we are consuming.

So I would see that as a more complicated question. And I, at least for a while, would do anything I could to get the deficits down.

So if indexing goes along with some adjustment of rates to reduce the deficit, then fine.

Representative **Hamilton**. What would you suggest we put in the bills to deal with the capital formation problem you mentioned?

Mr. **Gramlich**. Well, the big thing is just to get the deficit down. That is the single most important thing. And that would require, alas, some general rise in rates.

Representative **Hamilton**. You would not put any particular incentives into Bradley-Gephardt to encourage capital formation?

Mr. **Gramlich**. Here I'm going to sound very much like Congressman Kemp. The best thing we can do is have optimal economic allocation on the capital side by trying to eliminate the tax-induced distortions as much as possible. And I mention in my statement a few ways so we don't quite do that. But I wouldn't put any special fillips in, no.

Representative **Hamilton**. Is the fair tax or, for that matter, the FAST tax, as progressive as a tax system ought to be? Is it sufficiently progressive?

Mr. **Gramlich**. Well, I haven't done the numbers. I'll take the statement of other witnesses. If they basically preserve the present distribution across income classes, then so be it.

Now, I do think it is important to look above $100,000, and I wasn't totally satisfied with Congressman Kemp's answer to your question on that. So that is a problem with Kemp-Kasten. That would be something I would want to change. I don't see anything particularly holy about a flat rate all the way up. There are minor administrative and efficiency savings, but they are minor and there are major equity implications.

I am going to pass on the question of whether this is the right amount of redistribution in general.

Mr. **Musgrave**. Could I just add to this point.

It seems to me that whether these plans just keep the existing effective rate unchanged is not quite the right test, because under present law the departure between intended rates as given by statutory rates and actual rates as given by the observed effective rate increases as we move up the income scale. So I would not want to have a criterion which sanctions this increase over the upper ranges.

It seems to me that putting on a 25-percent flat rate would lead to an upper bracket rate vastly below those which would correspond to effective application of present statutory rates. And while one might not want to go as high as 50, it would seem that by comparison with present standards it ought to go higher at the upper end than you would get through a flat rate.

Representative **Hamilton**. Do you think these bills would pretty well put the tax shelter business out of business? In other words, you hear so many complaints about tax shelters from ordinary taxpayers. How much flexibility is there in Bradley-Gephardt or Kemp-Kasten for innovative tax lawyers to develop tax shelters? Much less, surely, than in the present code, but how much flexibility is there?

Mr. **Musgrave**. Well, they'd still have interest deduction. They would still have the housing preference. They would not any more have the exclusion of capital gains.

Representative **Hamilton**. Under Bradley-Gephardt?

Mr. **Musgrave**. Under Bradley-Gephardt, yes.

Representative **Hamilton.** You are reasonably well satisfied at this point that we would have removed the tax-shelter device from the Internal Revenue Code with both of these bills, and certainly Bradley-Gephardt? Is that a fair statement?

Mr. **Musgrave.** A substantial part, but we could do better by going after the interest deduction in particular.

Representative **Hamilton.** How do you feel about these bills as compared to some kind of consumption tax? Would you favor these versus a consumption tax?

Mr. **Gramlich.** No, I wouldn't. What I would be for is the best of all worlds—it will never happen and all that—but I would be for what is called a progressive expenditure tax, one that has progressive rates and that does tax bequests, because I would worry about the passing along of tax-free accumulations from generation to generation, building up enormous fortunes.

Of the family of consumption tax proposals, not every one has progressive rates and not every one taxes bequests. And I would be on the side of the redistribution on those.

Representative **Hamilton.** You would actually prefer that over either of these bills?

Mr. **Gramlich.** Over these, yes. The main reason for that is that there would be less distortion of taxation from income from capital. That would be the main reason.

Representative **Hamilton.** And it would create more encouragement for capital formation?

Mr. **Gramlich.** I think I would be rather modest in that claim. I don't think there will be a great increase in stimulation of private saving and investment. What there will be is elimination of tax-induced distortions if you had a good consumption tax.

There are some people who would claim it would also stimulate greatly private saving and investment, but I think that claim is very much overstated.

Representative **Hamilton.** Mr. Musgrave, do you want to comment on that generally?

Mr. **Musgrave.** I generally agree, provided that we look at an expenditure tax which is progressive, which includes bequests and which is pretty airtight in avoiding tax-free consumption, that all consumption would all be caught in the net of determining expenditures. But I don't worry that much about the efficiency cost of a broad-based income tax as compared to the expenditure tax, although it is a factor.

Let me add one point. It seems pretty plausible to say, "Well, let's tax expenditures. Let's tax consumption." Actually Hobbes said that a long time ago. He said that people should be taxed on what they take out of the pie, they consume, and not on what they put back into the pie. If they consume, it's selfish; if they save, it helps everybody.

Well, that may be a rather dubious argument, but it has some appeal. But viewed in another way, the expenditure tax looks rather shocking. When we are dealing with an expenditure tax; we are not only dealing with a tax which moves from income to consumption as tax base, but also with a proposal which makes the income tax into a tax on wage income only. As economists have pointed out, in the longer run the expenditure tax is really a tax on wage income. People may find it rather shocking that they should pay a tax on the earnings from their labor, but not on their capital income. Traditionally, going back to the Middle Ages it was thought that earnings from labor are in some sense more deserved than capital income. This would defend a change in the income tax law which would make it a tax on wage income only. Yet, that is what a change to the expenditure tax would do.

Representative HAMILTON. Both of our proponents, yesterday and today, talked about these bills being revenue neutral. How accurate are they? How good are you tax experts in calling that kind of thing?

Mr. GRAMLICH. In making revenue forecasts?

Representative HAMILTON. Yes. When they say they are revenue neutral, is that a shot in the dark? Do they have some strong empirical data to support it? Or do we really know?

Mr. GRAMLICH. One thing I do know about that is that you can't possibly make terribly precise calculations like this because you are changing a lot of provisions that will give private people incentives to do this or that or the other thing, and there is no way to make econometric estimates of how strong the elasticity is because in many cases these incentives haven't existed before. So there is not anything you can measure from the data and so forth.

Representative HAMILTON. How can they claim it's revenue neutral, then?

Mr. GRAMLICH. I assume what they do—I don't do this myself—is to make some best guess. They either assume what Congressman Kemp calls a static analysis, which is that nobody changes behavior at all and they just do the number. Or if they are more careful, they make estimates of how sensitive people are to this provision and that provision, and then they work it out, and what they give is the expected value of the midrange estimate.

So what they can claim is that expected revenue from this set of tax changes will be the same as actual revenue is now.

Representative HAMILTON. I take it you don't have much confidence in it, though.

Mr. GRAMLICH. I would just say—and I think they would, too—that this is an uncertain estimate, and there will be a range of possibilities. In statistical jargon, there's a standard error on that estimate. So you could be off by 5, 10, or 20 percent, up or down.

Mr. MUSGRAVE. It seems to me that the problem is not really that serious. One can certainly make static estimates. Assuming there are no incentive or disincentive effects, that can be worked out without too much difficulty. Then, if incentive effects work out favorably, we will be that much better off.

So one can say, "Isn't it prudent for Congress in undertaking the reform to use the static estimate to make sure we don't lose revenue, and if we gain so much the better, and we can reduce rates later on."

But these gains will take, say, 5 to 10 years to become apparent, so that in the short run the model which says, "We want to be sure we don't lose" is a plausible one. And on that point I think one can be pretty safe in making the estimates.

Representative **Hamilton.** All right. Thank you very much, gentlemen. We are very pleased to have had both of you, and your statements as well as your responses have been most helpful to us.

The subcommittee stands adjourned.

[Whereupon, at 12:20 p.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following information was subsequently supplied for the record:]

STATEMENT OF
INTERSTATE CARRIERS CONFERENCE

BEFORE

SUBCOMMITTEE ON ECONOMIC GOALS AND INTERGOVERNMENTAL POLICY
JOINT ECONOMIC COMMITTEE OF THE CONGRESS

ON

FAIR TAXATION

This statement is submitted for the record in the Subcommittee's hearings on fair taxation by the Interstate Carriers Conference, an affiliate of the American Trucking Associations representing some 750 common and contract trucking companies throughout the United States. These carriers vary widely, approximately 30 percent having revenues of less than $1 million and 20 percent having more than $10 million. No other group of carriers makes more extensive use of the services of owner-operators (independent contractors).

The federal tax structure where the trucking industry is concerned is particularly unfair because trucking is really not an "industry" in the sense of such huge industries as steel or auto production. Trucking is actually thousands of comparatively small independent businesses. Interstate Commerce Commission statistics show that of 25,722 trucking companies it regulates, 22,059 had annual revenues of less than $1 million.1/

1/ "The Surface Transportation Act of 1982: Comparative Economic Effects on the Trucking Industry," Report by the General Accounting Office to the Senate Committee on Finance; April 6, 1984; p. 13.

Compare that with our main competition, the tax-favored railroad industry. The rail industry consists of about 30 individual large carriers sharing revenues of nearly $30 billion.

There are four major areas of federal taxation where trucking companies are put at a severe competitive disadvantage in competing with railroads:

(1) The maximum federal "use" tax will more than double on July 1, 1984, to $550 per truck per year. That amount was raised in the Deficit Reduction Act of 1984 from $240.

(2) Starting August 1, 1984, truckers will pay 15 cents per gallon in federal tax on diesel fuel, increased by the same Act by 6 cents per gallon (additionally, for the Subcommittee's information, state taxation of diesel fuel used by trucks ranges from 6.5 to 18 cents per gallon).

(3) Truckers pay a 12 percent excise tax--really a sales tax collected at point of sale--on truck tractors and heavy trailers.

(4) Finally, as the staff of the Joint Congressional Committee on Taxation reported on November 14, 1983, the trucking industry's corporate income tax rate in 1982--36.9 percent--was second only to the rubber industry's 39.0 among 31 groupings.

In sharp contrast, we point out the comparable picture in each of those four categories for the railroads:

(1) There is no federal "use" tax on locomotives or rail cars.

(2) There is no federal tax on diesel fuel consumed by railroads, giving them an up-front advantage of 21 to 33 cents per gallon over trucks. 2/

2/ Since the Class I railroads alone consumed 3,100,000,000 gallons of diesel fuel in 1983, if there were a federal tax--which we strongly urge be enacted--every cent would produce at least $31,000,000 for the Treasury.

(3) Many rail trailers and vans are exempt from the sales tax, and in the Deficit Reduction Act cited earlier railroad piggyback highway equipment received a reduction from 12 to 6 percent in the sales tax.

(4) And the Joint Economic Committee staff report mentioned earlier showed the rail industry corporate income tax rate as a mere 4.1 percent.

Consider, as well, such government aid to the railroads as the approximately $830,000,000 for the Federal Railroad Administration in pending appropriations legislation and the fact that the federal government has invested a total of $7,650,000,000 in Conrail-related programs. [3] The federal government guarantees loans to railroads for capital improvements. The government provides "contractual support" for rail labor-management cooperative projects. Funds are provided to states to retain rail service over abandoned lines. The government operates an automated track inspection program. General funds help finance the railroad retirement program.

We in trucking have never taken the position that we are not willing to pay our fair share of taxes. But the key is "fair."

From the inception of the interstate highway program in 1956, we have endorsed the pay-as-you-go principle of the Highway Trust Fund--even as some of our user taxes have recently been diverted to urban mass transit subsidies. We have consistently taken the position that what is best for the country is a strong, competitive transportation system--truck, rail, barge, every mode.

Because it is obviously in the public interest to have strong alternative modes of transportation service available, almost every recent Congressional transportation regulatory enactment has stressed competition--fair competition--as its overriding purpose.

The exception is in taxation, rail versus truck.

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[3] "Department of Transportation and Related Agencies Appropriation Bill, 1985," House Committee on Appropriations; H. Rept. 98-833.

We maintain that the highway system we share with motorists is an indispensable national resource. The highways would exist even if there were no trucking industry, but how would they be paid for?

Obviously, trucks are vital to everyone in the country, but with all the obvious tax disadvantages stacked up against us it is going to be ever more difficult for our small, privately held companies to be able to compete with the railroads, which already enjoy enormously larger financial bases and in many cases have the advantage of huge conglomerates behind them.

If the Committee agrees from a social policy standpoint that healthy rail-truck competition is desirable, we urge that all possible be done to at least narrow these counterproductive tax inequities.

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Respectfully submitted,

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Suite 204
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June 28, 1984

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